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THE CARE AND FEEDING OF GRATs – ENHANCING GRAT PERFORMANCE THROUGH CAREFUL STRUCTURING, INVESTING AND MONITORING

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I. INTRODUCTION

The Grantor Retained Annuity Trust (the "GRAT") is one of the most powerful, currently available estate planning technique. A GRAT enables a grantor to transfer, free of gift tax, that portion of a transferred asset's future investment return that exceeds the rate of return §7520[1] requires the Internal Revenue Service ("IRS") to use to value annuity interests. Unlike outright gifts or sales, the GRAT delivers its benefits without any potential transfer tax disadvantage to the grantor or her family and the trusts she has created for them.

This outline explains how the GRAT technique works and discusses how to enhance its performance by carefully structuring its provisions, selecting its investments and monitoring its performance.

 This outline incorporates some materials and items from earlier outlines prepared by the author and Pam H. Schneider.

[1] References to "§" in this outline, unless otherwise indicated, refer to sections of the Internal Revenue Code of 1986, as amended (the "Code"). References to "Treas. Reg. §" refer to sections of the regulations promulgated by the Treasury under the Code.

II. DEFINING THE GRAT

A. In General.

A GRAT is a trust that pays an annuity to its grantor for a specified period of time. At the end of the period, the beneficial interest in the trust shifts to another beneficiary or beneficiaries.

If the terms of the trust satisfy the governing instrument requirements set forth in Treas. Reg. §25.2702-3, the grantor's interest is a "qualified annuity interest" and the value of the gift to the remainder beneficiaries is determined under §7520.[2]

The Code permits the value of the gift to the remainder beneficiaries to be determined under §7520 because the required structure of the GRAT seems to prevent the trustee from manipulating investment decisions for the purpose of shifting economic enjoyment between the trust's annuity and remainder beneficiaries. The annuitant is entitled to receive the annuity no matter what the trust's income is. As a result, a trustee whose object is to maximize the interest of the trust's remainder beneficiaries would have no incentive to maximize growth opportunities at the expense of current income.[3] So long as the total return, be it income or appreciation, is consistent with the Code § 7520 rate, a GRAT's annuitant and its remainder beneficiaries will each receive their appropriate share of trust assets.

B. Governing Instrument Requirements

There are eight governing instrument requirements, each of which is described briefly below:

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[2] §2702(a)(2)(B). If a grantor's retained interest in a trust for the benefit of members of her family is not a qualified interest and does not fit within one of the exceptions to the general rule of §2702, the value of her transfer for gift tax purposes is equal to the full value of the property transferred to the trust. For this purpose, the members of a grantor's family are her spouse, her ancestors and descendants, her siblings and the spouses of her ancestors, descendants and siblings.

[3] The trustee might, however, have an incentive to maximize the possibility of a higher overall return by making speculative investments. If the GRAT is structured initially with a zero or relatively small remainder interest, the risk burden will be borne entirely or almost entirely by the annuitant while the remainder beneficiary will enjoy the rewards but not the risks of a successful speculative investment.

1. Frequency of Annuity Payments

An annuity amount must be payable at least once in every twelve-month period to the holder of the annuity or the annuitant. The trust instrument must require pro-ration of the annuity payment made for a period of less than 12 months in the same manner as is required for charitable remainder annuity trusts under Treas. Reg. § 1.664-2(a)(1)(iv). The annuity must be paid to the annuitant whether or not the trust has produced income equal to the annuity. If income is insufficient, the trustee must be required to invade principal to pay the annuity.

The regulations require that the annuity must be paid no later than 105 days after the anniversary date of the creation of the trust if the annuity is payable based on the anniversary date and no later than the date on which the trustee must file the trust's income tax return (determined without extensions) if the annuity amount is payable based on the taxable year of the trust.[4]

2. Prohibition Against Use of Notes to Fund Annuity Payments

The regulations also provide that the GRAT instrument "must prohibit the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity . . . payment obligation."[5] This prohibition, however, does not prevent the use of notes issued by other persons to satisfy the payment obligation. In addition, it does not prevent the grantor from lending money to the GRAT for other purposes, including providing it with funds to make investments.

3. Fixed Amount Requirement

The annuity amount must be a fixed amount. By this the regulations mean an amount that is fixed in the trust instrument either in terms of a fixed dollar amount or in terms of a fixed percentage of the initial fair market value of the property

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[4] Treas. Reg. § 25.2702-3(b)(4). It is not clear whether express permission in the trust instrument to delay a payment nominally due on a particular date to a later date will be reflected in a lower valuation for the annuity. Arguably, such an annuity does have a lower value because of the trustee's power to deny the use of the annuity amount to the grantor for 105 days. If the trustee instrument does not expressly permit the trustees to delay payment, a grantor's failure to require timely payment could be viewed as a gift.

[5] Treas. Reg. § 25.2702-3(d)(5).

transferred to the trust, as finally determined for federal tax purposes.[6] The regulations do not require that the fixed amount be the same for each year. The only requirement imposed on variations in amounts payable from year to year is the requirement that an amount payable in one year not exceed 120% of the amount payable in the immediately prior year.

4. Formula Adjustment Requirement

The regulations permit the annuity amount to be defined as a percentage of or as a fraction of the value of the trust's assets as finally determined for gift tax purposes. If the formula approach is used, the trust instrument must contain a provision requiring adjustment of annuity amounts previously paid if an error was made by the trustee in determining the value. The adjustment clause must satisfy the requirements of Treas. Reg. § 1.664-2(a)(1)(iii), which deals with a similar problem in connection with charitable remainder annuity trusts.[7]

5. Additions

The trust instrument must prohibit additional contributions to the trust.[8]

6. Commutation

The trust instrument must prohibit "commutation."[9] By this term, the regulations refer to the pre-payment by the trustee of the annuitant's annuity interest.

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[6] Treas. Reg. § 25.2702-3(b)(1)(ii). The IRS will not ordinarily issue rulings on whether annuity interests are qualified annuity interests under Code Sec. 2702 if the amount of the annuity payable annually is greater than 50% of the initial net fair market value of the property transferred to the trust, or if the value of the remainder interest is less than 10% of the initial net fair market value transferred to the trust. Rev. Proc. 2006-3, 2006 I.R.B. 122 Section 4.01 (50).

[7] Treas. Reg. § 25.2702-3(b)(2).

[8] Treas. Reg. § 25.2702-3(b)(4).

[9] Treas. Reg. § 25.2702-3(d)(4). See PLR 9412036 (December 23, 1993) in which the IRS determined that the absence of a provision prohibiting commutation would preclude treatment of an interest as a qualified interest.

7. **Amounts Payable to Other Persons**

The trust instrument must prohibit payments from the trust before the expiration of the qualified interest to or for the benefit of any person other than the annuitant.[10] The charitable lead trust regulations contain a similar provision.[11]

8. **Term of the Annuity**

The term of the qualified annuity interest must be fixed in the trust instrument and must be for (i) the life of the annuitant, (ii) a specified term of years, or (iii) the shorter of those two periods.[12] Recently issued final regulations under §2702 make it clear that the full value of an annuity interest retained for a term of years is a qualified interest.[13]

III. **THE TAX CONSEQUENCES OF CREATING, FUNDING, ADMINISTERING AND TERMINATING A GRAT**

A. **Creating and Funding**

1. **Gift Tax Issues**

The value of a grantor's transfer to a GRAT for gift tax purposes is determined by subtracting from the value of the property transferred to the GRAT an amount equal to the actuarial value, determined under the tables prescribed by the Treasury pursuant to §7520, of the grantor's retained

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[10] Treas. Reg. § 25.2702-3(d)(2).

[11] Treas. Reg. § 25.2522(c)-3(c)(2)(vi)(f).

[12] Treas. Reg. § 25.2702-3(d)(3).

[13] 70 F.R. 9222-9224 (February 25, 2005). Example 5 of Treas. Reg. §25.2702-3(e) originally provided that only the portion of an annuity payable during the life of the annuitant is a qualified interest even though the annuity is actually payable for a term of years and any payments made after the annuitant's death are required to be paid to her estate. In December 2000 a unanimous Tax Court held in *Walton v. Commissioner* that Example 5 is invalid. *Walton v. Commissioner*, 115 T.C. 589 (2000). The Tax Court concluded in *Walton* that Congress intended to permit a grantor to retain qualified annuity interests for a specified term of years, that the appropriate method for doing so is to provide that the balance of any payments due after the grantor's death should be payable to her estate, and that Example 5 is an unreasonable and an invalid extension of §. 2702.

annuity interest.[14] The tables use an interest rate equal to 120% of the federal mid-term rate in effect under §1274 on the date of the gift. The interest rate is changed monthly.

In the case of an annuity payable for a fixed period of years, the actuarial value of the annuity is determined by four factors – (1) the period of time over which the annuity is payable, (2) the frequency of the payments, (3) the size of each of the payments and (3) the §7520 rate in effect in the month that the GRAT is created and funded. If the first three factors are held constant, the value of the retained annuity will increase with decreases in the §7520 rate. This is so because a decrease in the deemed rate of current return will tend to make the right to receive fixed amounts in the future more valuable.

The table below shows how changes in the §7520 rate will affect the amount of annuity payment necessary to produce an annuity with a value equal to the value of the transferred property if the payments are constant and are made annually over a 2, 5, 10, 15 or 20 year period.

Table 1

§7520 Rate	Annuity as % of Value of Transferred Property				
	2-Year GRAT	5-Year GRAT	10-Year GRAT	15-Year GRAT	20-Year GRAT
3.00%	52.26%	21.84%	11.72%	8.38%	6.72%
4.00%	53.02%	22.46%	12.33%	8.99%	7.36%
5.00%	53.78%	23.10%	12.95%	9.63%	8.02%
6.00%	54.54%	23.74%	13.59%	10.30%	8.72%
7.00%	55.31%	24.39%	14.24%	10.98%	9.44%
8.00%	56.08%	25.05%	14.90%	11.68%	10.19%
9.00%	56.85%	25.71%	15.58%	12.41%	10.95%
10.00%	50.75%	26.38%	16.27%	13.15%	11.75%

2. <u>Income Tax Issues</u>

A GRAT is likely to be a so-called grantor trust because the retained annuity interest is almost always worth more than 5% of the value of the trust at its inception.[15].

[14] §2702(a)(2)(B).

[15] §673.

As a result, the grantor will not recognize gain when she funds the GRAT with appreciated assets even if she transfers property to the trust that is subject to debt in excess of basis, such as partnership interests with negative bases.[16]

B. Administering

1. Income Tax Issues

Because the GRAT is a grantor trust, the grantor will not be taxed on the distributions she receives from the trust. Instead, she will be taxed on trust income whether or not it is distributed to her and all of the trust's deductions and credits will be treated as belonging to her. In addition, transactions between the trust and its grantor are generally ignored for all income tax purposes.

There are at least three significant benefits to a GRAT and its grantor that flow from grantor trust status:

(1) No gain or loss is recognized when the trust either sells an asset to or buys an asset from its grantor.[17] This principle permits a GRAT to use appreciated trust assets to satisfy its annuity obligation without recognizing gain.[18]

(2) A grantor may make an interest-bearing loan to a GRAT without being required to include the interest in her gross income.[19]

(3) The trust will be permitted to hold shares in an S Corporation.[20]

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[16] LR 9416009 (December 30, 1993); PLR 9230021 (April 28, 1992).

[17] Rev. Rul. 85-13, 1985-1 C.B. 184. But see Rothstein v. United States, 735 F.2d 704, 84-1 U.S.T.C. ¶ 9505 (2d Cir. 1984), in which the Second Circuit took a contrary position.

[18] E.g., PLR 9736029 (June 8, 1997); PLR 9736028 (June 9, 1997); PLR 9735034 (June 2, 1997); PLR 9625021 (March 20, 1996); PLR 9352017 (September 30, 1993); PLR 9352007 (September 28, 1993); PLR 9351005 (September 16, 1993); PLR 9239015 (June 25, 1992). In the absence of the grantor trust rules, a distribution of property other than cash to satisfy an annuity obligation of the GRAT would be a recognition event. Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); Suisman v. Eaton, 115 F.Supp. 113 (D. Conn. 1953) aff'd per curiam, 83 F.2d 1019 (2d Cir. 1936), cert. denied, 299 U.S. 573 (1936).

[19] PLR 9510929 (February 10, 1995).

[20] Code Sec. 1361(c)(2)(A)(i). See PLR 9352004 (September 24, 1993).

Until 2004, the IRS refused to give taxpayers the assurance that their payment of income taxes on the income earned by trusts treated as owned by them under § 671 would not be treated as taxable gifts. This changed with the issuance of Rev. Rul. 2004-64.[21]

In Rev. Rul. 2004-64, the IRS ruled that the grantor of a trust who is treated as the owner of the trust and who pays the income tax attributable to the inclusion of the trust's income in her taxable income is not treated as making a gift of the amount of the tax to the trust beneficiaries. Additionally, it ruled that if the trust's governing instrument or applicable local law, requires the trustee to reimburse the grantor for the income tax payable by the grantor that is attributable to the trust's income, the full value of the trust's assets will be includible in the grantor's gross estate under Code § 2036(a)(1).

2. Changing the Governing Instrument During the Annuity Term

The regulations do not impose any adverse consequences if the parties, the trustee and the beneficiaries, subsequently decide to disregard a requirement contained in the trust instrument. For example, as discussed above, the regulations require that the trust instrument prohibit prepayment of the annuity. In many states, the creator of a trust, with the consent of all of the beneficiaries, may revoke or amend the terms of a trust.[22] What would the consequences be under § 2702 if a trust that otherwise qualified as a GRAT were subsequently amended to provide a commutation clause?

The IRS might take the position that an amendment is a new transfer and, if the trust immediately after the amendment does not satisfy the regulations' requirements, subject the full value of the trust to gift tax. An amendment, however, that resulted in the simultaneous termination of the trust would probably not be vulnerable to a new application of §2702 since, immediately after the amendment, neither the transferor nor any other family member would have an interest in the trust.

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[21] 2004-27 I.R.B. 7.

[22] *See, e.g.*, Cal. Prob. Code § 15404; Fla. Stat. § 737.4032; and NY EPTL § 7-1.9.

C. Terminating

If there is property left in the GRAT to be paid to the GRAT's remainder beneficiaries when the GRAT ends, the property will pass to them free of gift tax. This will be so even if the creation of the GRAT was not treated as a taxable gift by the grantor because the value of the retained interest was treated as equal to the value of the property transferred. The transfer tax system does not permit the IRS to make any post-transfer adjustments in the value of transferred property to reflect the fact that its investment performance was significantly better than the assumed performance on which the original valuation was based.

No income tax will be imposed on the GRAT or its grantor when appreciated property is distributed to the GRAT remainder beneficiaries at the end of the GRAT. The basis of the distributed property, however, will be a carryover basis under §1015. If the distributed property is sold after the grantor's death or if it is sold by a remainder beneficiary that is not a grantor trust treated as owned by the grantor, the income tax imposed on the gain can significantly reduce the amounts that the remainder beneficiary retains.

Example 1: G creates a 5-year GRAT and transfers $1 million worth of X stock with a zero basis to the GRAT. G retains the right to receive an annuity equal to $234,700 per year for 5 years. Because the value of the right to receive $234,700 per year is worth $999,493, her creation of the GRAT will have resulted in a taxable gift of $507. During the 5-year term of the GRAT, the shares of X grow in value by 10% per year. At the end of the GRAT term, the remainder beneficiary will receive X shares worth about $177,643. When these shares are sold, unless the remainder beneficiary is a grantor trust, treated as wholly owned by the grantor, the beneficiary will pay a tax on its gain of $26,646 (assuming a 15% tax rate on long term capital gains), leaving it with only $150,997.

The tax on disposition issue can become more significant if the GRAT borrows funds to make the annuity payments to the grantor. Consider the following example:

Example 2: The trustees of the GRAT described in Example 1 borrowed to make all of the annuity payments to G. The loans carried an interest rate of 4.5%. At the end of the GRAT term, the remainder beneficiary received X stock worth $1,610,510, subject to a debt, including accrued interest, of $1,283,976. If the remainder beneficiary of the GRAT is not a grantor trust treated as owned by G, the termination of the GRAT will be a recognition event for G. She will be treated as having received long term capital gain income equal to the amount of the debt.[23] If the remainder beneficiary is a grantor trust but sells the X stock after G's death, it will pay income tax on the gain (assuming a 15% rate) of $241,576, leaving it with only $84,958 after paying its debt.

IV. STRUCTURING THE SUCCESSFUL GRAT

A. Creating GRATs With No Taxable Gifts

Creating a GRAT that produces anything other than a nominal taxable gift is generally tax inefficient. In fact, the ability to structure GRATs that will shift the economic advantage of the transferred property's investment return from the grantor to the GRAT's remainder beneficiaries without creating a taxable gift is one of the reasons to use the GRAT rather than an alternate estate planning technique. A GRAT will produce a zero taxable gift if the actuarial value of the retained annuity payments is equal to the value of the property transferred to the GRAT. A GRAT that is created without a taxable gift is generally referred to as a "zeroed-out" GRAT.

When a grantor incurs a taxable gift as a result of her transfer to a GRAT, there is a possibility that reverse leverage will produce a negative transfer tax result. If the transferred property fails to produce a rate of return equal to the §7520 rate, the gifted portion of the transferred property will be used to pay the required annuity to the grantor.

Consider this example:

Example 3: G creates a 10-year GRAT and transfers $1 million worth of stock in the X corporation to it in a month in which the §7520 rate is 5.6%. G retains the right to receive an annuity equal to $66,652 per year for 10 years. This transfer will create a taxable gift of $500,000 because the right to receive $66,652 per year for 10 years has an actuarial value of $500,000. The stock declines in value over the 10 year term. The annuity payments are made by distributing stock to G. The remainder beneficiary receives nothing. The grantor has either wasted $500,000 of her unified credit, protecting a gift from gift tax that resulted in no economic benefit to the donee, or has paid a gift tax on a gift that resulted in no economic benefit to the donee.

If the grantor had limited her transfer to the GRAT to $500,000 worth of the stock and had made an outright gift of the other $500,000 worth of stock, at the end of the 10-year period, the donee would have been left

[23] Treas. Reg. §1.1001-2(a); *See* TAM 200020020, 200010011, and 200011005 (November 29, 1999).

with one-half of the stock. Her unified credit or her payment of gift tax would not have been completely wasted.

B. Period of Time Over Which Annuity is Payable

1. Reasons to Choose a Short-Term GRAT

The 2-year term offers two advantages over a longer term.[24] First, it minimizes the possibility that a year or two of poor performance of the transferred property will adversely impact the over-all effectiveness of the GRAT. When a GRAT is funded with a volatile security, a series of short-term GRATs will generally perform better than a single long-term GRAT, the term of which is equivalent to the cumulative terms of the short-term GRATs. Tables 2 and 3 below compare the results of a 10 year GRAT with the results of a series of 5 2-year GRATs, each of which was funded at a time when the § 7520 rate was 4% and each of which was structured to produce a zero taxable gift. Both tables assume a rate of return on the GRAT's stock consistent with the performance of the NASDAQ Composite Index from 1993 through 2003. The tables show that the series of short-term GRATs leave the remainder beneficiary with significantly more value than does the long-term GRAT.

[24] An even shorter term would be more advantageous. But in setting the trust's term, care must be taken to avoid an argument that a trust's term is so short that it won't be recognized for tax purposes. In addition, it might be possible to interpret Code § 2702(b)(1) as requiring a period of at least two years, since it defines a qualified interest as "the right to receive fixed amounts payable not less frequently than annually." Private letter rulings have recognized the validity of 2-year GRATs. *See, e.g.*, PLR 9239015 (June 25, 1992).

Table 2

Long-Term GRAT

	Value of X Stock	% Increase or Decrease	Annuity Payment
1	$1,000,000	14.75%	$123,291
2	$1,024,209	-3.20%	$123,291
3	$868,143	39.92%	$123,291
4	$1,091,415	22.71%	$123,291
5	$1,215,985	21.64%	$123,291
6	$1,355,833	39.63%	$123,291
7	$1,769,859	85.59%	$123,291
8	$3,161,390	-39.29%	$123,291
9	$1,795,989	-21.05%	$123,291
10	$1,294,642	-31.53%	$123,291
	$763,151	Left for Remainder Beneficiary	

Table 3

Series of Short-Term GRATs

	Value of X Stock	% Increase or Decrease	Annuity Payment	Payment to Remainder Beneficiary	Grantor's Stock at End of Each GRAT	Value of Remainder Beneficiary's Stock
1	$1,000,000	14.75%	$530,196			
2	$617,304	-3.20%	$530,196	$67,354	$1,043,426	$67,354
1	$1,043,426	39.92%	$553,220			$94,242
2	$906,741	22.71%	$553,220	$559,442	$1,232,077	$675,086
1	$1,232,077	21.64%	$653,242			$821,175
2	$845,456	39.63%	$653,242	$527,268	$1,565,364	$1,673,875
1	$1,565,364	85.59%	$829,950			$3,106,544
2	$2,075,209	-39.29%	$829,950	$429,910	$1,333,812	$2,315,893
1	$1,333,812	-21.05%	$707,182			$1,828,397
2	$345,863	-31.53%	$345,863	$-	$830,070	$1,251,904

The choice between a series of short-term GRATs and a long-term GRAT is not as clear as the discussion above suggests. It is possible, for example, that an increase in the Code § 7520 rate between the time the first GRAT was established and the times the subsequent ones are established may outweigh the advantage of separating different years' investment experiences. Additionally, a change in tax law during the time a grantor planned to establish successive short-term GRATs might prevent the creation of some of the planned-for GRATs.

The second advantage the 2-year term has over a longer term is the reduced exposure to the risk that the grantor will die during the term. Some portion of the trust will be included in the gross estate of the grantor if she dies while the GRAT is in effect under 2036 or 2039 or some combination of the two. Each time one of a chronological series of short-term GRATs terminates and distributes its excess value to its remainder beneficiaries, the distributed amount is protected from possible inclusion in the grantor's gross estate.

2. <u>Reasons to Choose a Long-Term GRAT</u>

When funding annuity payments is likely to be a problem because of insufficient cash flow, a long-term graduated GRAT may provide a good solution. If the term is sufficiently long and if the annuity payments are scheduled to increase by 20% each year, the amount of required payments in the initial years will be quite small. The table below shows the percentage annuity payment required to be paid in GRATs that last, 10 years, 15 years, 20 years, and 25 years in order to produce a zero taxable gift using the assumption that the Code § 7520 rate is 5.6%.

Table 4

Years	Annuity %
10	13.305%
15	10.029%
20	8.437%
25	7.528%

The longer term has an additional advantage in a low interest rate environment of locking in the low interest rate applicable at the beginning of the GRAT.

On the downside, the longer term increases the possibility that the GRAT will fail to produce any transfer tax savings because the death of the grantor or investment losses occur before the end of the term. As discussed below, in many cases this risk can be managed by careful monitoring.

3. Capitalizing on Disparities Between Actual Life Expectancy and Life Expectancy Under IRS Tables

a. In General

GRAT terms are usually measured by fixed terms of years. If, however, the life expectancy of the grantor or her spouse is less than the life expectancy assumed in the IRS tables, a GRAT measured by the life of the grantor or her spouse may produce significant transfer tax savings.

b. Revocable Spousal Annuity

Use of a revocable spousal annuity payable for the duration of a spouse's life could achieve significant transfer tax savings if, at the time of the GRAT's creation, the spouse has less than the average life expectancy for a person of his age. The IRS is required to assume that a selected measuring life has an average life expectancy, as determined by tables set forth in the Treasury Regulations, no matter what the individual's actual life expectancy is unless she has an incurable illness or other deteriorating physical condition that gives her a 50% chance of dying within one year.[25]

Suppose, for example, that the grantor's 50-year old spouse has a condition that decreases his life expectancy substantially but which is not expected to cause his death within a year. The donor could create a GRAT the terms of which provide that the spouse is to receive an annuity payable for the remainder of the spouse's life. The value of the revocable interest, which would be treated as an incomplete gift for gift tax purposes, would be calculated as if the spouse were expected to live for another 33 years. This calculation is likely to cause a significantly higher portion of the transfer to be treated as an incomplete gift than the actual value of the spouse's revocable interest in the GRAT. If the donor transferred $1,000,000 to a GRAT to pay a $100,000 annuity to her spouse for the rest

[25] Treas. Reg. §§ 25.7520-1(b)(2) and 25.7520-3(b)(3).

of the spouse's life in a month in which the IRS rate is 5.6%, she would be able to reduce the amount of her taxable gift by $948,000, the actuarial value of a 50 year old's right to receive $100,000 per year for life from a $1,000,000 fund. If the property produces a rate of return of 5.6% and the spouse dies within two years, property worth almost $910,000 can pass to the grantor's children at the price of a gift tax on only $52,000.[26]

c. **Measuring the Term of the GRAT by the Grantor's Life**

Similar results can be achieved if the grantor's life expectancy is less than the life expectancy assumed in the IRS's tables unless she has an incurable illness or other deteriorating physical condition that gives her a 50% chance of dying within one year. In this case, a GRAT term measured by the grantor's life followed by a gifted remainder interest would not achieve any transfer tax savings because the full value of the trust property would be included in the grantor's gross estate under §2036. Transfer tax savings would be achieved, however, if the grantor created a GRAT in which she retained an annuity for life and simultaneously sold the remainder interest for its full actuarial value. In this case, §2036's exception for transfers for adequate and full consideration in money or money's worth should protect the GRAT from inclusion in the grantor's gross estate.[27]

C. The Amount of Each Annuity Payment

1. Using a Formula to Define the Annuity Amount

When a GRAT is funded with difficult to value assets, such as, for example, interests in family limited partnerships, the amount of the annuity payment should be defined by formula. The use of a

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[26] Treas. Reg. § 25.2701-2(a)(6) defines a "qualified interest" as a revocable interest payable to the transferor's spouse so long as the interest meets the requirements of a qualified interest but for the transferor's retained power to revoke the interest.

[27] *See Estate of Magnin v. Commissioner*, 184 F.3d 1074 (9th Cir. 1999); *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997); *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309 (3d Cir. 1996) *cert. denied*, 520 U.S. 1230 (1997). *But see, Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (Fed Cir. 1990)

formula to define the amount of the annuity rather than a provision that requires the payment of a specific dollar amount protects the GRAT's grantor from any significant gift tax if the IRS successfully challenges her valuation. The consequence of a successful challenge would be an increase in the amount of her annuity.

Consider the following example.

Example 4: G creates a 10-year GRAT and transfers what she believes to be $1 million worth of stock in the X corporation to the GRAT it in a month in which the §7520 rate is 4%. G retains the right to receive an annuity equal to $123,100 per year for 10 years. This annuity will protect $1 million worth of transferred property from the gift tax because the right to receive $123,100 per year for 10 years has an actuarial value of $1,000,000. If the IRS successfully argues that the shares of X Corp. transferred to the GRAT were worth $2,000,000, double her estimate, the amount of G's taxable gift will be $1 million. If, instead, the terms of G's GRAT had defined her annuity amount as the minimum amount necessary cause her Annuity Payments to have a value equal to 99% of the fair market value of the transferred X stock as finally determined for federal gift tax purposes. G's taxable gift would be 1% of the value put on the X stock by the IRS. Any increase in value would cause the trust to be required to increase her annuity payment from the amount she had thought it would be to the amount necessary to cause her taxable gift to be 1% or, in this case, $20,000.[28]

To some individuals, the ability to define a difficult-to-value gift by means of a formula will be the most important advantage of establishing a GRAT. Other taxpayer approaches toward minimizing valuation risks by means of various types of adjustment clauses have generally been rejected by the IRS.

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[28] It is possible to provide a formula that produces an annuity with a value exactly equal to the value of the transferred property. If there is a possible valuation problem, however, the IRS might attempt to apply the so-called *Procter* doctrine. In *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), the Fourth Circuit invalidated, for gift tax purposes, an agreement that required a transferee to return property to a transferor if the transfer was held to be subject to the gift tax. The Fourth Circuit said that the agreement was void as against public policy since "it has a tendency to discourage the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift." A formula that produces a small taxable gift should avoid this risk.

Clauses that require post-transfer adjustments in the price of a purchased asset or in the quantity of property transferred, if the value of the transferred property is later determined to be greater than the original estimate, with few exceptions, have been rejected by the courts and by the IRS.[29]

A formula clause that works simultaneously with (rather than after) the gift and works to define the amount of the gift should not be disregarded by the IRS because, without the clause, there would be no way to determine the amount of the gift. The following is an example of a definitional formula clause:

> "I hereby transfer to the trustees of the T Trust a fractional share of the property described on Schedule A. The numerator of the fraction is \$100,000 and the denominator is the value of such property as finally determined for federal gift tax purposes."

The IRS objects to this kind of clause as well as the adjustment clauses discussed above because it forces the IRS to use its limited resources to challenge taxpayer valuations even though a successful challenge would not produce any immediate additional tax revenue.[30] The Tax Court considered the validity of this type of clause in *McCord v. Commissioner* in 2003. It rejected the

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[29] *E.g., Ward v. Commissioner*, 87 T.C. 78 (1986); *Harwood v. Commissioner*, 82 T.C. 239 (1984); Rev. Rul. 86-41, 1986-1 C.B. 300; TAM 9309001 (Sept. 30, 1992). *But see King v. United States*, 545 F.2d 700 (10th Cir. 1976). For discussions of this issue *see* McCaffrey, *Tax Tuning the Estate Plan by Formula*, 33-4 Univ. of Miami Law Center on Estate Planning § 4 (2000); Peterson, *Savings Clauses in Wills and Trusts*, 13 Tax Mgmt. Est., Gifts & Trusts Journal 83 (1988) and McCaffrey & Kalik, *Using Valuation Clauses to Avoid Gift Taxes*, 125 Tr. & Est. 47 (Oct. 1986). *But see McCord v. Commissioner*, 120 T.C. 358 (2003), in which the Tax Court suggested that it might have honored a valuation clause if the valuation standard had been the value of the transferred property as finally determined for federal gift tax purposes.

[30] A 2001 Non-Docketed Service Advice Review opinion as to whether a savings clause which gifted limited partnership interests to be valued at certain dollar amounts should be recognized for tax purposes warned against recognizing formula clauses. "To give substance to this clause effectively nullifies our regulations, defeats the gift tax, obstructs justice and hampers the administration of the tax laws. . . . Fair administration of the gift tax will become even more difficult if formula clauses are given effect, for scarce resources cannot reasonably be expended examining returns if the examination will have no tax effect. 2001 IRS NSAR 0417, 2001 WL 34056189 (IRS NSAR)(2/27/01).

particular clause used by the taxpayers in McCord because the clause failed to link the value to be used to measure the gift to the value as finally determined for gift tax purposes.

It may be that a definitional formula clause with the appropriate tie-in to final gift tax values will be upheld by the courts. But until it has been, the GRAT provides the only sure way to protect against the gift tax risk of valuation challenges.

For individuals who want to make gifts of difficult to value property, combining a gift with a GRAT may permit the GRAT's valuation formula to protect the gift from unanticipated gift tax. For example, suppose G wants to transfer $1 million worth of the shares of X Corp. to a trust for the benefit of C, her child. She believes that 100 shares have a value of $1 million but is unwilling to pay a gift tax on any value of these shares in excess of $1 million. She could transfer 101 shares of X Corp. to the trustee of a GRAT, the terms of which require the trustee to pay her an annuity for 5 years, the actuarial value of which is equal to the excess, if any, of the value of the transferred property over $1 million.

2. <u>Using a Pattern of Increasing Annuity Amounts</u>

As discussed above, the regulations permit a GRAT to make different annuity payments each year of its term so long as the amount to be paid in any year is determinable from inception and so long as the payment in any one year does not exceed the payment in the preceding year by more than 20%. In general, a pattern of increasing annuity payments will produce more value for the beneficiaries at the end of the term than would a pattern of constant annuity payments if the property grows in value at a relatively constant rate throughout the term of the GRAT. The table below shows the annuity percentages required to zero out a GRAT assuming a 4.2% §7520 rate, a pattern of annuity payments that increases the annuity payment each year by 20% and terms of 20 years, 15 years, 10 years and 5 years.

Table 5

Years	20 Years	15 Years	10 Years	5 Years
1	0.998%	2.161%	5.091%	15.405%
2	1.197%	2.593%	6.110%	18.486%
3	1.437%	3.112%	7.332%	22.183%
4	1.724%	3.734%	8.798%	26.619%
5	2.069%	4.481%	10.557%	31.943%
6	2.482%	5.377%	12.669%	
7	2.979%	6.452%	15.203%	
8	3.575%	7.743%	18.243%	
9	4.290%	9.291%	21.892%	
10	5.148%	11.149%	26.270%	
11	6.177%	13.379%		
12	7.413%	16.055%		
13	8.895%	19.266%		
14	10.674%	23.120%		
15	12.809%	27.744%		
16	15.371%			
17	18.445%			
18	22.134%			
19	26.561%			
20	31.873%			
NPV	100.000%	100.000%	100.000%	100.000%

Table 6 shows the extra value passing to the remainder beneficiaries of a 20 year and of a 15 year GRAT, assuming increasing GRAT payments rather than constant payments. In each case, a 4.2% §7520 rate an annuity pattern sufficient to zero out the taxable gift, and an annual investment return of 10% are assumed.

Table 6

		20 Years					15 Years		
Year #		Increasing Payments		Constant Payments			Increasing Payments		Constant Payments
		$1,000,000		$ 1,000,000			$1,000,000		$ 1,000,000
1	1.00%	$1,090,023.51	7.49%	$1,025,109.25		2.16%	$1,078,391.54	9.12%	$1,008,796.57
2	1.20%	$1,187,054.06	7.49%	$1,052,729.42		2.59%	$1,160,300.53	9.12%	$1,018,472.79
3	1.44%	$1,291,393.32	7.49%	$1,083,111.61		3.11%	$1,245,214.40	9.12%	$1,029,116.64
4	1.72%	$1,403,293.27	7.49%	$1,116,532.01		3.73%	$1,332,396.41	9.12%	$1,040,824.87
5	2.07%	$1,522,935.33	7.49%	$1,153,294.46		4.48%	$1,420,828.74	9.12%	$1,053,703.93
6	2.48%	$1,650,404.15	7.49%	$1,193,733.16		5.38%	$1,509,142.85	9.12%	$1,067,870.89
7	2.98%	$1,785,654.92	7.49%	$1,238,215.72		6.45%	$1,595,534.60	9.12%	$1,083,454.54
8	3.57%	$1,928,472.82	7.49%	$1,287,146.54		7.74%	$1,677,661.03	9.12%	$1,100,596.57
9	4.29%	$2,078,423.01	7.49%	$1,340,970.44		9.29%	$1,752,514.70	9.12%	$1,119,452.79
10	5.15%	$2,234,788.79	7.49%	$1,400,176.73		11.15%	$1,816,271.24	9.12%	$1,140,194.64
11	6.18%	$2,396,495.84	7.49%	$1,465,303.65		13.38%	$1,864,104.45	9.12%	$1,163,010.67
12	7.41%	$2,562,019.23	7.49%	$1,536,943.26		16.06%	$1,889,962.20	9.12%	$1,188,108.30
13	8.90%	$2,729,269.73	7.49%	$1,615,746.83		19.27%	$1,886,295.19	9.12%	$1,215,715.70
14	10.67%	$2,895,454.99	7.49%	$1,702,430.76		23.12%	$1,843,728.83	9.12%	$1,246,083.84
15	12.81%	$3,056,910.43	7.49%	$1,797,783.08		27.74%	$1,750,666.65	9.12%	$1,279,488.79
16	15.37%	$3,208,893.41	7.49%	$1,902,670.64					
17	18.44%	$3,345,333.07	7.49%	$2,018,046.95					
18	22.13%	$3,458,526.75	7.49%	$2,144,960.89					
19	26.56%	$3,538,771.89	7.49%	$2,284,566.23					
20	31.87%	$3,573,920.03	7.49%	$2,438,132.10					

D. <u>Using Single Asset GRATs</u>

A grantor who has more than one asset the future return of which she would like to protect from transfer taxes by using the GRAT technique should consider transferring each asset to a separate GRAT. Multiple GRATs for separate assets prevent underperforming assets from diluting the effectiveness of the good performers. The principle is the same as the one that recommends use of a chronological series of short-term GRATs rather than a single long-term GRAT to maximize the advantage to the remainder beneficiaries of the years of good investment return.

This approach obviously adds complexity but can substantially enhance the ability of the GRAT technique to shift value to the next generation. Suppose, for example, that G, had two assets she wished to transfer to a 2-year GRAT - $500,000 worth of shares of the X Corp. and $500,000 worth of shares of the Y Corp. in a month in which the §7520 rate was 4.2%. Suppose during the 2-year term of the GRAT that the shares of X increased by 10% per year and that the shares of Y decreased by 10% per year. If she had established a single GRAT and had funded it with the shares of X and Y, at the end of the 2-year term, there would be nothing in the trust to pass to her remainder beneficiaries. The excess return on the X stock would be needed to compensate for the poor performance of the Y stock. On the other hand, if she had established two GRATs and had funded one with the shares of X and the other with the shares of Y, the remainder beneficiary would have received property worth $46,698 at the end of the 2-year term.

E. Using Clauses That Reimburse the Grantor for Income Taxes

Many grantors would like their trustees to have the power to reimburse them for their income tax liability attributable to trust income, in order to provide them with relief from the tax burden if, in the future, they believe they can no longer afford to sustain it. Rev. Rul. 2004-64, discussed above, concludes that the mere existence of that discretion, by itself (whether or not exercised) will not cause the value of the trust's assets to be includible in the grantor's gross estate but that this discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between the grantor and the trustee regarding the trustee's exercise of this discretion; a power retained by the grantor to remove the trustee and name herself as successor trustee; or applicable local law subjecting the trust assets to the claims of the grantor's creditors) may cause inclusion of Trust's assets in the grantor's gross estate for federal estate tax purposes.

If it is unclear whether local law would subject trust property to the claims of its grantor's creditors because of a trustee's power to reimburse her for her income taxes attributable to trust income, inclusion of a reimbursement provision would be risky. In such a case, the reimbursement provision should, by its terms, be operative only if, as a matter of law in the applicable state, the reimbursement provision would not cause the trust assets to be subject to the claims of the grantor's creditors.

F. Planning for the Marital Deduction

The possible application of the marital deduction should be considered in connection with the creation of a GRAT. If a portion of a GRAT is included in the grantor's gross estate, and if she is survived by her spouse, the marital deduction could be disallowed for any portion of the included interest even if the transferor bequeaths her entire estate to her surviving spouse.[31]

[31] As of May 31, 2005, but effective as to all trusts, regardless of when created, New York law has provided, "[A] disposition in trust shall not be considered to be for the use of the creator under paragraph (a) of this section by reason of the trustee's authority to

Suppose, for example, that the terms of the GRAT require any annuity amounts payable after the death of the grantor to be paid to the grantor's estate and that the remainder is to be paid to her children. Suppose also that, under the grantor's will, annuity payments received by the estate are to be paid to the surviving spouse. Because the trust will end in favor of the remainder beneficiaries, the annuity payable to the surviving spouse will be a nondeductible terminable interest.[32] To avoid this result, the GRAT might give the grantor a power of appointment exercisable over such portion of the trust as is includible in her gross estate. She could then exercise this power in favor of her husband. If the grantor's husband is to receive both the remaining annuity payments and the property held in the GRAT at the end of its term, the nondeductible terminable interest rule will not apply. Alternatively, the power of appointment could be exercised in favor of a marital deduction trust to which the grantor specifically bequeaths her remaining annuity payments.

G. <u>Avoiding Spendthrift Clauses</u>

Drafters often include a provision in trust agreements that prohibit trust beneficiaries from transferring their interests in trusts to others. These clauses should not be used to prevent GRAT beneficiaries from transferring their interests for two reasons.

First, in two recent cases, *Gribauskas v. Commissioner* [33] and *Shakleford v. United States of America* [34] the Second Circuit and the Ninth Circuit, respectively determined that transferability restrictions should be taken into account in valuing annuity payments to be received by lottery winners despite §7520's rules for valuing annuities. It is possible that the IRS may try to turn these decisions against taxpayers by using them to decrease the value of a retained interest in a GRAT if the grantor has no

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pay trust principal to the creator pursuant to section 7-1.11 of this article. Nor shall a disposition in trust be considered to be for the use of the creator under paragraph (a) of this section where the trustee is authorized under the trust instrument or any other provision of law to pay or reimburse the creator for any tax on trust income or trust principal that is payable by the creator under the law imposing such tax or to pay any such tax directly to the taxing authorities. No creditor of a trust creator shall be entitled to reach any trust property based on the discretionary powers described in this paragraph." New York Estates, Powers and Trusts Law § 7-3.1(d).

[32] §2056(b)(1).

[33] 342 F.3d 2003 (2d Cir. 2003).

[34] 262 F.3d 1028 (9th Cir. 2001).

power to transfer her right to receive future payments. Any such attempt should fail because §2702(a)(2)(B) requires that the value of a qualified interest be determined under §7520.

Second, as discussed in further detail below, there may be good transfer tax reasons for arranging for the grantor or remainder beneficiaries to sell or otherwise dispose of their interest in a GRAT.

H. Identifying the Remainder Beneficiaries

In order to maintain flexibility for dealing with future circumstances, the grantor of a GRAT should consider designating a separate grantor trust as the remainder beneficiary of her GRAT. The beneficiaries of the separate grantor trust should include beneficiaries who are assigned to the grantor's children's (or higher) generation in order to prevent the termination of the annuity period from being treated as a taxable termination for generation-skipping transfer tax purposes.[35] Inclusion of the grantor's spouse as a beneficiary will ensure that GRAT profits are available for his support if the other assets of the grantor and her spouse become insufficient. Use of a grantor trust will enable the grantor to continue to pay the income taxes on the investment earnings of the GRAT profits. It will also prevent the imposition of income tax on the grantor if, at the time of the GRAT's termination, the GRAT holds property subject to a debt in excess of its basis and will enable the grantor to purchase appreciated property from the remainder beneficiary trust for cash or other property with a basis equal to fair market value in order to eliminate the tax disadvantage to the remainder beneficiary trust, after the grantor's death, of holding low basis property. And use of a separate trust will facilitate future transfers of the remainder interests, as discussed below, to minimize estate tax exposure.

Use of a separate grantor trust may also facilitate generation-skipping transfer tax planning. Assume, for example, that a grantor created a grantor trust a number of years ago and allocated her GST exemption to it ("Trust #1"). Its assets are now worth $1 million. The beneficiaries of Trust #1 include her children, grandchildren and more remote descendants. All future distributions from Trust#1 to the grantor's grandchildren or more remote descendants will be free of generation-skipping transfer taxes because of the GST exemption allocation. The grantor creates a 5-year GRAT in a month in which the §7520 rate is 4.2%. She transfers property worth $1 million to it. She is entitled to receive an annuity of $220,000 at the end of each of the next 5 years. The actuarial value of the right to receive these annuity payments is $974,000. As a result, she

[35] §2612(a)(1).

has made a taxable gift of $24,000. The remainder beneficiary of the GRAT is a separate grantor trust for the primary benefit of her children ("Trust #2). The grantor does not allocate any GST exemption to this new trust because §2642(f) (the so-called "ETIP" rule) would prevent the allocation from being effective until the end of the 5-year term of the GRAT. Six months later, when the actuarial value of the remainder beneficiary's remainder interest in the GRAT is worth $100,000, Trust #2 sells its remainder interest to Trust # 1 for a price equal to its value of $100,000. The sale, so long as the price paid is equal to the then value of the GRAT remainder interest should not be treated as an addition from the unprotected trust to the protected trust. As a result, when the GRAT remainder is paid to the protected trust, the transfer should not be subject to generation-skipping transfer tax. And when distributions are made from Trust #1 to the grantor's grandchildren, the distributions should not be treated as taxable distributions

Alternatively, the GRAT remainder beneficiary could enter into a contract with the protected trust to pay to the protected trust an amount equal to the value of the remainder interest at the end of the GRAT. The protected trust would pay the GRAT remainder beneficiary, at the time the contract is entered into, an amount equal to the then value of the remainder interest.[36]

I. <u>**Targeting the Profit Level**</u>

Most GRATs are structured to deliver all of the increase in value of the GRAT's assets over the § 7520 rate to the remainder beneficiaries, no matter how great that increase may be. In some cases, however, a grantor is willing to create a GRAT for the benefit of her children but wants to insure that she will receive property with a certain specified value back from the GRAT and/or that her children's trust will receive property worth no more than a certain maximum value. It is possible to structure a GRAT's provisions to deliver to the remainder beneficiary precisely the amount that the grantor wants it to have so long as the GRAT's property appreciates sufficiently.

For example, suppose G owns $10 million worth of stock in a closely held business that she expects will be sold over the next several years for a price of more than $20 million. She would like her children's trust to receive $5 million of this increase and would like to use the GRAT technique to accomplish this result. But she wants to make sure that she receives back property from the GRAT worth at least $15 million. Her

36 This idea is discussed in Handler and Oshins, *The GRAT Remainder Sale*, 142 Tr. & Est. 33 (Dec. 2002).

GRAT would provide first that she is to receive an annuity in an amount sufficient to almost zero-out her taxable gift, say 22.59% of the initial value each year if the GRAT is a 5-year GRAT created in a month in which the §7520 rate is 4.2%. It would then provide that the grantor is to receive, at the end of the GRAT term, property with a value equal to $15 million reduced by the aggregate amount of the five annuity payments, that the children's trust is to receive the balance of the property remaining in the GRAT up to an aggregate amount of $5 million and that the grantor is to receive the balance of the property.

V. SELECTING INVESTMENTS TO ENHANCE THE PROBABILITY OF SUCCESS

A. In General

A successful GRAT is one that produces a remainder interest with a positive value at the end of the annuity term. In order to produce such a positive value, the GRAT's internal rate of return, taking into account the timing of its investment gains and losses and the timing of its annuity payments must exceed the §7520 rate in effect at the time of the GRAT's creation.

Normally, it is impossible to predict accurately the rate of return for any particular investment. Nevertheless, there are certain assets and investment approaches that can enhance the probability of success. These assets and approaches are discussed in this portion of the outline.

B. Using Assets Subject to Restrictions

Some assets are subject to transferability restrictions that are expected to lapse at some future time. Examples include restricted securities that cannot be sold for some period of time because of SEC rules, because of lock up agreements entered into in connection with initial public offerings, or because of employer conditions imposed in connection with the issuance of stock to employees. In most cases, the owner of these shares expects these restrictions to disappear over a period of time. In many cases, the restrictions on transfer will not prevent intra-family transfers, including transfers to GRATs for the benefit of family members.

The existence of these restrictions will provide a basis for discounting the value of the property if it is transferred to a GRAT. If the term of the GRAT extends beyond the term of the restrictions and if a source of funding can be found to satisfy annuity payments that are required before the restrictions are lifted, this kind of property is a likely candidate for transfer to a GRAT.

Suppose, for example, that G owns 100,000 shares of the X corporation the shares of which are traded on the New York Stock Exchange at $10 per share. G's shares, however, cannot be sold by her or her transferees for a period of two years. Assume that this restriction on transferability would result in a valuation discount of 25%.[37] Assume that G transfers her shares to a 2-year GRAT at a time when the §7520 rate is 4.2%. She retains the right to a payment equal to 53.17% of the value of the shares ($398,787) at the end of each of the two years. The actuarial value of the right to these two payments is equal to $750,000, the discounted value of her shares. At the end of the first year, her trustees borrow $398,787 from a financial institution to make the required payment to her. At the end of the second year, the trustees sell the stock for $1 million, pay the financial institution $415,000 (including interest), and pay G the second annuity payment. Because the GRAT is a grantor trust for income tax purposes, all of the tax on the gain is paid by G, not by the GRAT. After the required payments are made, there is $186,000 left for the remainder beneficiaries of the GRAT.

This GRAT succeeded despite the fact that the market value of the stock transferred to it did not appreciate in value. The success was entirely attributable to the existence of restrictions at the beginning of the GRAT period that the GRAT creator knew would be lifted before the end of her GRAT.

C. <u>Using Assets With Limited Marketability</u>

The value of some assets, such as non-controlling interests in family controlled entities and fractional interests in tangible property, is determined for gift tax purposes using discounts from the value of their proportional interest in their underlying assets to reflect lack of marketability. For example, the value of each of 25% of the stock in a family business that could be sold for $10 million, a 25% limited partnership interest in a partnership that owns $10 million worth of marketable securities and a 25% interest in a $10 million home is not $2.5 million. Valuation discounts of varying proportions would be used to determine their value for gift tax purposes. If the term of the GRAT extends beyond the period of time that the assets are expected to have limited marketability and if a source of funds can be found to satisfy annuity payments that are required before a market for the property is created, this kind of property is a likely candidate for transfer to a GRAT.

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[37] This discount is assumed for illustrative purposes only. The discount allowed for any particular security must be established by a qualified appraiser who will take into account many factors specific to the corporation and the trading pattern of its shares.

Suppose, for example, that G owns all of the stock of a corporation engaged in the manufacturing business. The corporation could be sold for $10 million. G has no present intention of selling the corporation but believes that it is likely to be sold at some time during the next 5 years. She transfers a 25% interest in the corporation to a 5-year GRAT at a time when the §7520 rate is 4.2%. She retains the right to a payment equal to 22.59% of the value of the shares as finally determined for gift tax purposes at the end of each of the five years. Assume that the value of the shares is $1.375 million after taking a valuation discount of 45%. G would have the right to receive $310,599 at the end of each of the five years. The actuarial value of the right to these five payments is equal to $1,375 million, the discounted value of her shares. At the end of each of the first 4 years, the trustee borrows the funds necessary to make the annuity payments to G. During the fifth year, the corporation is sold to a third party for $10 million. The GRAT's share of the proceeds is $2.5 million. Because the GRAT is a grantor trust for income tax purposes, all of the tax on the gain is paid by G, not by the GRAT. The trustees use the cash to repay the financial institution $1.372 million (including interest), and pay G the final annuity payment of $310,599. After the required payments are made, there is $818,000 left for the remainder beneficiaries of the GRAT.

This GRAT succeeded despite the fact that the market value of the corporation did not appreciate in value. The success was entirely attributable to the elimination of the marketability discount by reason of the liquidity event that occurred during the term of the GRAT.

D. <u>Using Compensatory Stock Options</u>

Compensatory stock options give an employee the right to purchase shares of stock at a price generally equal to the market price of the stock at the time the option is granted. The IRS has ruled that the gift of such an option is a completed gift when the employee's right to exercise it is no longer conditioned on her performance of services.[38] The fair market value of such options for gift tax purposes is not limited to its intrinsic value, i.e., an amount equal to the excess of the stock's market value over the exercise price. It is generally determined using one of the standard option valuation methods such as the Black-Scholes model. These methods take into account factors such as the exercise price, the current value of the optioned stock, the stock's volatility, expected dividends, the risk-free rate of return over the option's life and the option's remaining life. The IRS has stated that it will accept, for gift and estate tax purposes, a value for non-publicly traded compensatory options derived

[38] Rev. Rul. 98-21, 1998-1 C.B. 975.

using the Black-Scholes model or a similar binominal valuation model.[39] As a condition for relying on this safe harbor, the transferor is not permitted to use any marketability discounts generally used in valuing options.

Despite the fact that the use of a Black-Scholes derived value for an option will produce a value in excess of the option's extrinsic value, the transfer of compensatory options can produce excellent results when compared with the transfer of shares of the underlying stock. This is so because of the leverage inherent in the option. If, for example, a share of X stock with a value of $100 is transferred to a GRAT, a 100% increase in the value of the X stock, will produce an increase in value for the GRAT of $100. If an option to purchase that share of stock for 10 years at a price of $100 is transferred to the GRAT, that same 100% increase will translate into a greater percentage increase in value for the GRAT so long as the initial option value is less than the value of the share of stock. Suppose, for example, that the option value determined using the Black-Scholes model is $30. By transferring an asset worth $30, the grantor transfers the right to receive the return on an asset worth $100. As a result, a 100% increase in the value of the stock will result in a value for the option of at least $100, more than a 200% increase in value for the GRAT.

Options valued using the Black-Scholes model are not particularly attractive candidates for outright gifts because the option leverage would work against the grantor if the stock failed to appreciate sufficiently in value. As a practical matter, the option itself will not be sold in a market transaction. As a result, the donee will never be able to capitalize on the value of the option itself but will only realize a return if she is able to exercise the option and sell the underlying stock. Unless the value of the stock increases sufficiently to offset the initial value of the option, the gifted option will eventually be worth less than its original value. For example, suppose the X stock describe above grows in value to only $125 before the option expires. In that case the donee will eventually realize $25 from the gifted property yet the donor will have made a taxable gift of $30. Transferring options to a zeroed-out GRAT protects against this reverse leverage. If the stock fails to appreciate sufficiently, the option or the stock will be returned to the grantor with no gift tax cost and no impact on her adjusted taxable gifts.

E. <u>Enhancing the Performance of a GRAT with Derivatives</u>

If a grantor transfers a marketable security to a GRAT, particularly a highly volatile stock, the possibility of success can be increased if the

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39 Rev. Proc. 98-34, 1998-1 C.B. 983.

grantor purchases a call on the stock from the GRAT. Suppose, for example, that the grantor transfers $10,000,000 worth of a highly volatile marketable security to a 5-year GRAT. As discussed above, Rev. Proc. 98-34[40] establishes a safe harbor for valuing, for gift tax purposes, compensatory stock options that are exercisable to acquire publicly traded stock. The revenue procedure. provides that such options can be valued by using a generally recognized option model such as the Black-Scholes model or an accepted version of the binomial model. The Black-Scholes model would value a 5-year call, the exercise price of which is double the stock's current value, at about 60% of the market price of the stock if the stock is highly volatile.[41] Using Black-Scholes as a basis for establishing value, the grantor or her spouse could purchase from her GRAT the right to buy the $10,000,000 worth of stock at any time during the 5-year term of the GRAT for $20,000,000. She would pay $5,983,000 for the call. With the purchase price as part of its assets, unless the stock declines in value substantially, the GRAT will succeed in producing value at the end of its term for the remainder beneficiary. If, for example, the stock remains at its current level throughout the GRAT's term, at the end of the term, the GRAT will have assets for its remainder beneficiary worth about $5,700,000.

VI. MONITORING THE GRAT

A. In General

A GRAT's performance should be monitored in order to curtail losses generated by an unprofitable GRAT, to protect a profitable performance from erosion as a result of future investment losses and to protect a profitable performance from disappearance as a result of the premature death of the grantor.

B. Monitoring to Minimize the Impact of Investment Losses

A GRAT that underperforms in its initial years is unlikely to be a profitable GRAT. This is so because losses in the early years must be compensated for by better than average gains in the later years.

Suppose, for example, that G creates a 5-year GRAT in a month in which the §7520 rate is 4.2%. She transfers property worth $1 million to it. She is entitled to receive an annuity of $225,900 at the end of each of the next 5 years. The actuarial value of the right to receive these annuity

[40] 1998-1 C.B. 983.

[41] Calculation provided by Lance Hall of FMV Opinions, Inc.

payments is $1 million. Suppose, the value of the property declined by 10% in each of the GRAT's first two years. It is now worth only $380,808, and will be required to make three more payments of $225,900 to the grantor. In order to produce any profit at all for the remainder beneficiary, the GRAT's investments would have to grow in value by more than 35% per year in each of the next three years. Except in unusual circumstances, this is unlikely to happen.

When losses of this magnitude occur, the grantor should consider purchasing the GRAT's remaining assets and transferring them to a new GRAT. Because the GRAT is a grantor trust, the purchase can be accomplished without income tax cost. The grantor could pay the purchase price with a note, portions of which would be distributed to him over the remaining term of the GRAT.[42] With a fresh start, the property in the new GRAT would have a significantly better opportunity for producing a profit for the remainder beneficiary.

C. Monitoring to Protect Investment Gains

A GRAT that generates good investment performance in its initial years is likely to produce a profit for its remainder beneficiaries, but there is no guarantee that poor performance in later years will not substantially reduce its profitability. A GRAT's successful investment results can be locked in by one of two different transactions.

First, the grantor could purchase the GRAT's assets for a note. Because the GRAT is a grantor trust, the purchase can be accomplished without income tax cost. She could then transfer the assets to a new GRAT. If the interest rate on the note is equal to the §7520 rate that was in effect when the GRAT was created, whatever profit has been generated prior to the sale will remain intact until the end of the GRAT term.

Second, the grantor could purchase the remainder interest from the remainder beneficiary. If the remainder beneficiary is a separate grantor trust treated as owned by the grantor, the purchase can be accomplished without income tax cost.

Suppose, for example, that that G creates a 5-year GRAT in a month in which the §7520 rate is 4.2%. She transfers property worth $1 million to

[42] Treas. Reg. §25.2702-3(b)(1)(i)'s prohibition against the issuance of a note or other debt instrument in satisfaction of the annuity amount does not apply to notes issued by persons other than the GRAT itself.

it. She is entitled to receive an annuity payment of $225,900 at the end of each of the next 5 years. The actuarial value of the right to receive these annuity payments is $1 million. At the end of the 5-year term, the remaining GRAT property is to be paid to a separate grantor trust for the benefit of her children. Suppose, the value of the property increased by 20% in each of the GRAT's first two years. It is now worth $943,041, and will be required to make three more payments of $225,900 to the grantor. The net present value of the right to receive these payments is $624,495 (assuming a §7520 rate of 4.2%). Therefore, the present value of the remainder interest is $318,545. The grantor could lock in the profit generated by the GRAT by purchasing the remainder interest from the separate grantor trust for $318,545. The grantor would then own all interests in the trust, the right to receive annuity payments and the right to receive the remainder at the end of the 5-year term. And the separate grantor trust would have cash of $318,545, the amount of which would not be affected by future investment performance of the GRAT assets.

D. <u>Monitoring to Protect Against Mortality Risk</u>

If a grantor dies while she has the right to receive further annuity payments from her GRAT, some portion, or all, of the GRAT will be included in her gross estate for federal estate tax purposes under § 2036. This section requires that a transferor include in her gross estate the value of property transferred during her life if she retained for life, or for a period that did not end before her death, the right to the income from the transferred property.

The grantor of a GRAT does not explicitly retain the right to income. Instead, she retains the right to an annuity which may be more or less than the actual income received by the trust. The IRS treats this type of retained interest as if it were the right to receive the income from a portion of the trust corpus. That portion is required to be included in the gross estate. The included portion is that fraction of the corpus which would be required to be invested at the § 7520 rate in effect on the date of the grantor's death to produce annual income equal to the required annuity payment.

In several private letter rulings the IRS has taken the position that the gross estate of a decedent who died before the termination of her right to receive an annuity from a GRAT must include the full value of the trust corpus under §2039(a).[43] This section requires inclusion of the value of

[43] PLR 20021009 (Nov. 19, 2001); FSA 200036012 (Sept. 8, 2000); PLR 9451056 (Sept. 26, 1994); PLR 9448018 (Aug. 30, 1994); PLR 9345035 (Aug. 13, 1993). The IRS had earlier reached a similar result in a private letter ruling dealing with a charitable remainder unitrust. PLR 8321104 (Feb. 24, 1983).

an annuity or other payment receivable by any beneficiary by reason of surviving the deceased annuitant under a contract or other agreement under which an annuity or other payment was payable to the decedent

The estate tax inclusion risk can be managed by using a separate grantor trust as the GRAT's remainder beneficiary and causing the grantor to purchase the remainder interest from the separate grantor trust at some time during its term after the performance of the GRAT's investments has caused the remainder interest to have significant value.

Suppose, for example, that a grantor established a 20-year GRAT using the annuity schedule set forth in Table 5 and funded it with an asset worth \$1,000,000. At the end of the 20-year term, the remainder was to pass to a separate grantor trust. Suppose further that the asset increased in value by 20% per year over the first 5 years. At the end of the 5-year period, the GRAT assets would be worth about \$2.4 million and the present value of the remainder interest (assuming a 4.2% § 7520 rate) would be about \$1.2 million. The grantor could purchase the remainder interest from the separate grantor trust for \$1.2 million. This purchase would eliminate the risk that the \$1.2 million value that had accrued for the benefit of the remainder beneficiary would be subject to estate tax if the grantor died before the end of the 20-year term.

Alternatively, at the end of the 5-year period, the separate grantor trust could purchase the assets of the GRAT for a self-canceling installment note that would terminate on the death of the grantor with no further payments due. If the grantor died before the 20-year term of the GRAT had expired, no further payments would be due on the note, and little, if any, value would be included in the grantor's gross estate.[44]

[44] Harrison, *Case Studies – Implementing Bright Ideas*, 38-19 Univ. of Miami Law Center on Estate Planning § 1902.4 (2004).

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