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Repercussions of *Walton*

Estate Tax Inclusion of GRAT Remainders

By Michael D. Whitty

The trend toward creating *Walton* GRATs increases the importance of the extent to which a grantor's estate includes the GRAT if the grantor dies during the term. The IRS's position, which asserts full or almost-full inclusion through Code §§ 2039 and 2036, is flawed and deserves to be challenged. To address this issue, practitioners should draft *Walton* GRATs with contingent provisions that do not assume the GRAT will be fully includible in the event of the grantor's death during the term.

GRATs, Generally

The grantor retained annuity trust (GRAT) is a trust that pays an annuity back to the grantor for a term of years (the "GRAT term"), with the remaining assets (the "GRAT remainder") passing to the beneficiaries named by the grantor in the trust agreement. Because the grantor's annuity interest is a "qualified interest" for purposes of Code § 2702, the value of the gift to the grantor's beneficiaries is only the actuarial value of the remainder interest and not the full value of the assets transferred to the GRAT. The extent to which the GRAT will be included upon the grantor's death during the GRAT term ("GRAT inclusion") will depend on which provisions of the Code apply.

Two recent Tax Court cases generated a trend toward creating GRATs following the pattern of that created by Audrey Walton in the eponymous Tax Court case: zeroed-out GRATs with payments continuing to the grantor's estate upon the grantor's death during the GRAT term and without a reversion to the grantor, a succeeding interest that is revocable by the grantor, or a general power of appointment. *Walton v. Commissioner,* 115 T.C. 589 (2000), acq. Notice 2003–72; *Cook v. Commissioner,* 269 F.3d 854 (7th Cir. 2001); cf. *Schott v. Commissioner,* 319 F.3d 1203 (9th Cir. 2003), rev'g *Schott v. Commissioner*, 81 T.C.M. (CCH) 1600 (2001). This trend may result in more situations in which a grantor dies without any interest that would require inclusion of the entire GRAT under Code §§ 2037, 2038, or 2041.

TAM 200210009 (the "TAM") expresses the IRS's aggressive position that the gross estate of a grantor who dies during the GRAT term includes more than the present value of the remaining annuity payments through Code §§ 2036 and 2039. The author believes the TAM's position is flawed and deserves to be challenged.

Scope of Analysis and Governing Assumptions

This article will analyze only GRATs created under the *Walton* model, in which (1) upon the grantor's death during the GRAT term, the remaining annuity payments are payable to the grantor's estate, and (2) the remainder is not subject to any reversion to, or any power of revocation or redirection by, the grantor that would cause GRAT inclusion under Code §§ 2037, 2038, or 2041. Although it is possible to design a GRAT with powers or interests that could cause GRAT inclusion under those sections, this article will assume that the donor had no compelling nontax reason to include such provisions. This article will further assume as a baseline for GRAT inclusion that Code § 2033 will bring in at least the present value of the remaining annuity payments ("Annuity NPV")—the only interest expressly retained by the grantor under this article's assumptions—as measured under Code § 7520, and that there are no unusual circumstances that would bring into play any of the other inclusion sections apart from Code §§ 2036 and 2039. Reference to a "*Walton* GRAT" will assume a GRAT

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meeting those conditions. These assumptions will narrow the focus of this article to whether Code §§ 2036 or 2039 requires that the grantor's estate must include some portion of the GRAT beyond the Annuity NPV.

The IRS's Position

The IRS position on *Walton* GRAT inclusion, as set forth in the TAM, first includes a new argument that the entire GRAT is includible under Code § 2039, which deals with annuities. The TAM also argues, in the alternative, that the assets held in a *Walton* GRAT are included under Code § 2036 to the extent of the amount needed to generate sufficient income to pay the remaining annuity payments from income alone, without touching principal.

Intuitive Analysis

Before beginning a technical analysis of the question of the extent of GRAT inclusion, it is helpful to step back and consider the problem intuitively. In a *Walton* GRAT, the grantor retains the right to a stream of annuity payments of a fixed amount payable out of income or principal for a fixed term, with any payments scheduled for after the grantor's death payable to the grantor's estate. The grantor retains no other continuing economic interest in or power over the remainder of the *Walton* GRAT. The annuity payments are the only interest the grantor retains, and that retained annuity interest has a value for gift tax purposes determined under Code §§ 2702 and 7520. If the grantor survives the GRAT term, the grantor will have received the lesser of the entire GRAT or all of those annuity payments, but never *more* than the value of the annuity payments. The grantor's economic position is not distinguishable in any material economic way from that of a lender holding a secured, nonrecourse promissory note. It seems counterintuitive that the IRS would insist on claiming that GRAT inclusion would bring in a larger amount than the grantor could have ever received by surviving the GRAT term, when the estate of an otherwise similarly situated lender would include only the unpaid portion of the loan's principal balance and accrued interest.

Consider the following example, which highlights the peculiarity of the IRS position. Assume twin sisters Kaye and Elle, both wealthy widows, create identical three-year *Walton* GRATs funded with identical property worth $237,487 on July 15, 2003, when the Code § 7520 rate was 3%. Each grantor is entitled to receive an annual annuity payment of $100,000 for each of three years. Their GRATs' investments are wildly successful, and as the end of the GRATs' three-year term approaches the Code § 7520 rate has climbed to 5%, and it appears that each GRAT will have $2.5 million remaining after the third and final annuity payment of $100,000. While returning home from celebrating their good fortune on the night of July 14, 2006, the sisters are involved in a common accident at 11:30 p.m. Kaye dies instantly, but Elle lingers in a hospital for 25 hours before succumbing to her injuries at 12:30 a.m. on July 16.

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Elle survived her GRAT's term. Her estate receives the final GRAT payment that accrued while she lay in the hospital, and the beneficiaries she designated in her GRAT instrument receive the remainder that vested upon accrual of the final payment. Elle's executor files an estate tax return listing the accrued but unpaid final GRAT payment as a receivable valued at $100,000, but listing a zero amount for the includible value of the GRAT itself.

Kaye died one day short of surviving her GRAT's term. Kaye's executor files the estate tax return setting forth the facts, listing the includible value of her GRAT as the Annuity NPV (in this case, the final annuity amount of $100,000). Kaye's return makes all necessary disclosures to assure protection by the statute of limitations and to minimize exposure to penalties.

The IRS accepts Elle's estate tax return but audits Kaye's return and assesses additional tax based on an increase in the gross estate. Consistent with its stated position in the TAM, the IRS asserts that under Code § 2039, Kaye's estate includes the entire $2.5 million value of the GRAT or, in the alternative, that under Code § 2036 Kaye's estate includes $2 million worth of the GRAT property (the $100,000 final payment divided by the then-current Code § 7520 rate of 5%). At a 46% marginal rate (ignoring state death taxes, if any), the *additional* tax assessed (before penalties, if any, and interest) would be $1,104,000 or $874,000, respectively, depending on whether Code §§ 2039 or 2036 applied.

What a difference a day makes! Of course, the timing of death can often affect inclusion or valuation in ways that are unquestioned. A case in point is Code § 2035, which specifically requires survival for three years after surrendering certain powers or interests to avoid estate tax inclusion. Another case would be the grantor's death before the end of a term income interest in a grantor retained income interest (GRIT) (including, since the advent of Code § 2702, a QPRT or personal property GRIT), in which the grantor has retained an income interest that falls squarely within Code § 2036. Nevertheless, the disparity in consequences for the estates of Kaye and Elle creates an intuitive sense that something is wrong with the IRS position, in a way that would not be the case if the disparity in consequences were clearly the intent of Congress.

The IRS's Code § 2039 Argument

The TAM correctly summarizes the general rule of Code § 2039, which states in pertinent part that "the gross estate shall include the value of an annuity or *other payment* receivable by any beneficiary *by reason of surviving the decedent* under any form of contract or agreement. . . ." Code § 2039(a) (emphasis added). The TAM correctly includes in the gross estate the remaining annuity payments payable to the GRAT grantor's estate under the TAM's facts. The TAM then erroneously argues that the GRAT remainder is an "other payment" payable to the remainder beneficiaries "by reason of surviving" the grantor.

The TAM is simply wrong on this last point. As apparently argued by the taxpayer's counsel during the estate tax audit, absent a provision for an alternative contingent distribution upon the grantor's death during the GRAT term, the remainder beneficiaries are not taking as a consequence of surviving the grantor. Instead, they are taking as a consequence of surviving the GRAT term. These beneficiaries receive the same amount that they would have received if the grantor had survived the GRAT term—no more, no less, and no sooner.

The TAM attempts to address this argument, but to call its logic circular would be an insult to circles, which are at least geometrically consistent and aesthetically symmetrical. The TAM sets forth a hypothetical using very different facts from the case before it, in which the grantor's estate would include annuity payments received by an alternate beneficiary after the death of the grantor. Code § 2039 inclusion of those annuity payments is not in question, but inclusion of the GRAT remainder is a different matter, which the TAM attempts to gloss over.

The GRAT remainder is neither an annuity payment nor an "other payment" subject to Code § 2039. The TAM apparently attempts to argue that Treas. Reg. § 20.2039–1(b) would bring in the GRAT remainder as an "other payment." But all the definitions and examples in that regulation appear to define an "other payment" as either a payment of the same kind as that received by the decedent before death or a lump-sum death benefit payable after the decedent's death. The TAM argues that the bene-

ficiaries receiving the GRAT remainder are receiving it because of having survived the decedent, notwithstanding the fact they are receiving it because of having survived the GRAT term without regard to the timing of the decedent's death. The TAM attempts to support this argument by assuming that the beneficiaries were also designated to receive the annuity payments payable after the decedent's death. Because those beneficiaries are receiving the postmortem annuity payments by virtue of surviving the decedent, the IRS argues that everything else they receive (including the GRAT remainder) must also be includible under Code § 2039, whether or not it is contingent on surviving the decedent. The TAM goes on to argue that everything the GRAT remainder beneficiaries receive must be includible under Code § 2039 *even if* those beneficiaries *do not* receive the postmortem annuity payments or anything else contingent on surviving the grantor/decedent. By supposing the GRAT remainder beneficiaries had an additional interest that clearly would be includible (which, in reality, they do not actually have) and using this fictional interest to argue that other distinguishable interests must therefore be includible, the TAM makes an argument that is the equivalent of supposing that if pigs had wings, they could fly.

A *Walton* GRAT remainder is not the equivalent of postmortem commercial annuity payments or lump-sum death benefits payable to a designated beneficiary from a retirement plan. Instead, it is the equivalent of the surplus retained by the issuer of a commercial term annuity after satisfaction of all annuity payments or other payments under the contract or an account surplus forfeited upon termination of employment under a nonvested employee retirement plan. Under the logic of the TAM's Code § 2039 position, that surplus would be an "other payment" received by means of surviving the annuitant and would be includible along with the

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remaining annuity payments or lump-sum death benefits that are to be paid to designated beneficiaries. This author does not expect the IRS to seek inclusion of the issuer's or plan's retained surplus in such instances because the IRS knows the retained surplus is not an "other payment" for purposes of Code § 2039. Assuming competent presentation of arguments by a taxpayer's counsel, the author believes that a reasonable court is likely to find the GRAT remainder to be analogous to the retained surplus rather than an "other payment" includible under Code § 2039.

The TAM's Code § 2039 argument for inclusion of the GRAT remainder is tendentious at best. It is a *non sequitur* without any basis in a relevant precedent or any logical argument. Although the TAM does cite several authorities in support of its argument for Code § 2039 inclusion of the GRAT remainder, all of those authorities relate to survivor annuity payments or death benefits. See *Commissioner v. Clise,* 122 F.2d 998 (9th Cir. 1941); Rev. Rul. 55–302; Rev. Rul. 76–404. It also creates possible unintended consequences: Code § 2036 inclusion allows a Code § 2207B right of reimbursement, but Code § 2039 does not, although applicable state law may create such a right of reimbursement. The author expects any competent taxpayer's counsel to make short work of the TAM's Code § 2039 argument if and when an appropriate case is litigated.

The IRS's Code § 2036 Argument

The TAM's position on Code § 2036 inclusion can be refuted with some careful "archeology" to trace its origins. The TAM recites no specific authority for the inclusion of an amount necessary to provide the remaining annuity under Code § 2036. Instead, the TAM relies on Rev. Rul. 82–105, 1982–1 C.B. 133, which addressed the amount of a life CRAT running for the life of the recipient that must be included in the grantor's estate upon the grantor's death. Here, the IRS made a critical mistake. It would not have been unreasonable to analogize from a precedent regarding a term CRAT, but a lifetime CRAT is another matter. The IRS is therefore using the *wrong formula* to determine the appropriate *Walton* GRAT inclusion amount under Code § 2036.

Rev. Rul. 82–105, relying on *Pardee v. Commissioner,* 49 T.C. 140 (1967), acq. 1973–2 C.B. 3 (1973), uses the formula *PMT/i* to determine the includible amount. This formula calculates the present value of a payment stream, where *PMT* is the amount of a given annual payment and *i* is the interest rate (today, the Code § 7520 rate, or in these earlier precedents, the rate determined under the predecessor sections). In *Pardee,* the trustee/grantor's power to distribute trust property for his dependents' support was expressly limited to income. It was therefore appropriate for the Tax Court to use the formula *PMT/i* to recalculate the value of the income interest to be included, because principal was not distributable for the purpose. Rev. Rul. 82–105 may have been correct to use the *PMT/i* formula, because the CRAT's annuity continued for life, and therefore the amount includible had to be sufficient to pay the annuity indefinitely without amortizing principal.

It is, however, demonstrably *wrong* to use *PMT/i* to calculate the inclusion of a *fixed-term* CRAT or GRAT. This is

Suggested GRAT Inclusion Formula

The Annuity NPV can be calculated as a factor using just two variables, i and t, as follows:

i = interest rate, here the Code § 7520 rate.

t = term (of years, or whatever period on which the interest rate is based).

Remainder Interest	R = (1/(1+i))t
Income Interest	I = 1 – R
Annuity Interest	A = I/i = (1–R)/i
Annuity Interest	A = (1 – (1/(1+i))t)/i

The factor calculated from the formula above is then multiplied by the original principal amount to determine the annuity payment amount, assuming constant payments. (A more complicated process is used for payments that increase each year.) The inverse of the annuity factor above, or 1/[(1 – (1/(1+i))t)/i], when multiplied by the amount of a given annuity payment, will yield the amount necessary to support that annuity payment from income and principal.

because the annuity payments are not payable solely from income but also from principal. The question is not "what is the amount of principal necessary to generate payments of a certain amount from income only, for any period of time (or an indefinite period of time)." The correct question is "what is the amount of principal necessary to generate a fixed number of payments of a fixed amount from both income *and principal*." The correct formula to use for a level fixed term annuity is not PMT/i but $1/[(1 - (1/(1+i))t)/i]$, which when multiplied by the payment yields the principal amount required to support the annuity payment for the given term. Because principal can be amortized along with income to satisfy a fixed-term annuity, a much smaller amount is required to support the annuity. This smaller amount happens to be the Annuity NPV.

Consequence of the IRS's Arguments

The IRS made two aggressive but faulty arguments in the TAM in an attempt to support GRAT inclusion of an amount much larger than the Annuity NPV. The IRS's Code § 2039 argument was logically flawed. Its Code § 2036 argument cited correctly decided precedents but incorrectly extrapolated from them to assert that the portion included under Code § 2036 is based on a formula that is appropriate for an income-only annuity or an annuity for an indefinite period. If inclusion under Code § 2039 or under Code § 2036 is limited to the Annuity NPV, then only the Annuity NPV should be includible under Code §§ 2033, 2036, and 2039.

ETIP Implications

This article accepts that at least the Annuity NPV will be includible in the grantor's estate upon the grantor's death during the term. Code § 2642(f)(3) prohibits effective allocation of GST exemption during an estate tax inclusion period (ETIP). Treas. Reg. § 26.2632–1(c)(3) provides that if any part of a trust is subject to an ETIP, the entire trust is treated as subject to an ETIP. If this regulation is valid, then the inclusion of even the GRAT payments in the grantor's estate makes the entire GRAT (not just the Annuity NPV) subject to the ETIP rules and prevents allocation of GST exemption until the last GRAT annuity payment is made and the ETIP ends. If GST exemption cannot be (or simply is not) allocated to the GRAT remainder at the beginning of the GRAT, then the first opportunity to allocate GST exemption will be at the

end of the GRAT term (or on the earlier death of the grantor). This eliminates the leverage advantage that would otherwise make allocation of GST tax exemption to GRAT remainders a very valuable tool.

If the "ETIP as to all if ETIP as to any" rule of Treas. Reg. § 26.2632–1(c)(3) is extra-statutory or otherwise invalid, then, if there is no inclusion beyond the Annuity NPV, there would be no reason the grantor could not allocate GST tax exemption to the GRAT remainder. It might make a stronger test case if the remainder had a value above zero at the time exemption is allocated. One could argue that Treas. Reg. § 26.2632–1(c)(3) is an extra-statutory overreach to the extent it imposes an ETIP over an entire trust when only a limited and defined amount is actually includible. This would be an aggressive argument to make, and it would be tough to be a test case, but with enough at stake a taxpayer might find it worth the attempt. One case in which it might be worthwhile to take a position contrary to this regulation would be a large GRAT with a remainder payable into a trust for the grantor's child and her descendants, when the child dies after formation of the GRAT but before the due date for the gift tax return. The "deceased parent move-up rule" for generation assignment under Code § 2651(e) would not be applicable under the circumstances. Without allocation of GST tax exemption, a taxable termination will occur at the end of the GRAT term, when the remainder is paid over to a trust entirely for skip persons. If the GRAT shows early signs of being successful from an investment standpoint, it might be worthwhile to allocate GST tax exemption to the remainder on a timely filed gift tax return that explicitly sets out what is being done and includes Form 8275-R to disclose that the return takes a position contrary to the regulation. The return could take the position that Treas. Reg. § 26.2632–1(c)(3) is invalid and that GST exemption can be allocated to a GRAT remainder but that, in the alternative, if that regulation is determined to be valid, the allocation will have no effect. In such a case, the taxpayer is taking on the IRS but not risking a waste of GST exemption.

Conclusion

The IRS's aggressive position asserting total or near-total GRAT inclusion is demonstrably incorrect. It deserves to be challenged and defeated in the courts soon, so that grantors and planners can implement *Walton*-type GRATs, knowing that GRAT inclusion will involve only the interest truly retained by the grantor, that is, the annuity payments. Without any need for a reversion or revocable spousal interest, planners can design GRATs without such provisions and can otherwise plan to minimize the amount includible in the grantor's estate. ■