Chapter LL

The Ins and Outs of GRATS, With a Discussion of GST Planning

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Biographies

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I. Introduction and Overview

A Grantor Retained Annuity Trust ("GRAT") is one of the most effective estate planning techniques for transferring appreciation out of a taxpayer's estate and for doing so tax-free. A GRAT works primarily by betting that assets transferred to a GRAT will appreciate at a rate higher than the Internal Revenue Service's measuring standard (the section[1] 7520 interest rate) during the GRAT term. If the GRAT assets do appreciate at a higher rate than the 7520 rate, and the Settlor of the GRAT survives the GRAT term, all such appreciation in the assets passes to the beneficiaries of the GRAT free of gift and estate tax. Once the retained annuity term is over, the assets in the GRAT are out of the taxpayer's estate and no longer subject to estate tax. However, there are certain generation-skipping-tax ("GST") pitfalls that must be considered when creating and administering a GRAT. We will discuss these GST implications in greater detail below. As we will also discuss below, it is possible to structure a GRAT so that virtually no gift tax is due upon funding.

Because of the general low-risk aspect of GRATs (if a GRAT is not successful, the assets are merely back in the taxpayer's estate and the taxpayer has not lost anything other than time and effort and the cost of administering the GRAT), GRATs have become highly popular among wealthy taxpayers looking to transfer assets out of their estate. A recent article in Bloomberg estimated that GRATs have cost the US federal government over one hundred billion dollars in tax revenue since the year 2000.[2] These tax savings calculations are based upon filings which are made with the US Securities and Exchange

[1] All references to "section" are references to a section of the Internal Revenue Code of 1986, as amended.

Commission. As an example, the Bloomberg article highlighted casino magnate Sheldon Adelson who has given at least $7.9 billion to his heirs by using a series of GRATs, while avoiding approximately $2.8 billion in gift taxes and removing the assets from his estate.

Other famous and wealthy taxpayers who have used GRATs include Facebook founder Mark Zuckerberg and Goldman Sachs CEO Lloyd Blankfein. Although GRATs created by billionaires illustrate the dramatic tax savings and make for interesting headlines, the GRAT is a very common and effective estate planning technique for "regular" US citizens seeking to reduce their US federal estate and gift tax liabilities.

It is not surprising then, that for several years GRATs have been on the federal government's "hit list" for either elimination or modification. Since Barack Obama became President in 2009, there has been a rising tide of expression of concern over income and economic inequality in our society. The result of this concern has been new proposed laws designed to increase transfer taxes on the wealthy and to limit the effectiveness of various estate planning techniques, including the GRAT. For example, recent proposals include (i) creating a minimum term for GRATs, (ii) prohibiting zeroed-out GRATs, (iii) limiting the grantor's ability to pay US federal income tax on income generated from GRAT assets, and (iv) limiting the length of time a GRAT and other trusts can exist without the trust or beneficiaries paying US federal estate, gift, or generation-skipping transfer tax. However, to date, such efforts have been unsuccessful and the GRAT lives on as a popular and effective estate planning tool.

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[2] http://www.bloomberg.com/news/2013-12-17/accidental-tax-break-saves-wealthiest-americans-100-billion.html

II. General Description of GRAT Structure

For purposes of this outline we will use a sample married couple as an example to facilitate discussion: Mr. and Mrs. Smith. Mr. Smith creates a GRAT by transferring assets to an irrevocable trust (i.e., a grantor retained annuity trust). The trust is for the benefit of one or more non-charitable beneficiaries and Mr. Smith retains a right to receive an annuity from the trust for a term of years.

Zeroing out the GRAT

For gift tax valuation purposes, the amount of Mr. Smith's taxable gift is the fair market value of the property transferred minus the value of his retained annuity interest. It is possible, however, and in fact recommended to structure the GRAT as a "zeroed-out" GRAT. A zeroed-out GRAT is a GRAT in which the value of the taxpayer's retained interest is equal to the value of the property transferred to the trust, resulting in a remainder interest and thus gift tax value of zero (or very close to zero). The benefit of the zeroed-out GRAT is obvious: Mr. Smith does not have to use any of his unified credit or pay gift tax to fund his GRAT.

The United States Tax Court decision of Walton v. Commissioner, 115 T.C. 41 (2000), supports the creation and use of zeroed-out GRATs and they have become, in the years since the decision, an established and common technique of sophisticated estate planners. In the Walton case, Sam Walton's widow, Audrey, set up two GRATs, each funded with approximately $100 million of Wal-Mart stock. Each GRAT had a two-year term and provided for Mrs. Walton to receive 49.35 percent of the initial value in the first year and 59.22 percent in the second. Although the combined percentages exceeded 100 percent, Mrs. Walton hoped the value of the stock would increase enough to pay the annuities and, after the GRAT term, pass to the beneficiaries, her daughters, gift-tax free. The IRS contended, however, that there was a chance that Mrs. Walton would die during the two-year term and, if this occurred, the remaining portion of the annuity would be paid to her estate. The IRS took the position that this "contingent" interest of her estate was not a qualified remainder interest under IRC section 2702 and therefore it could not be included in the value of the annuity to be subtracted from the entire value of the Wal-Mart stock to calculate the taxable gift. The IRS relied heavily on Example 5 of section 25.2702-3(e) of the Gift Tax Regulations to support its position.[3]

Fortunately for Mrs. Walton, the tax court refused to draw a distinction between the annuity to be paid to Mrs. Walton and that which would be paid to her estate if she died. The court noted that a person cannot make a gift to his or her own estate, and any such transfers are regarded under law as retained by the donor. Noting that an interpretative regulation such as section 25.2702-3(e) must implement the intent of Congress, the court said that Congress' intent was for the IRS to use the existing rules governing charitable remainder annuity trusts (CRATs) as guidance when creating regulations for valuing GRATs. The court found it "incongruous" that, with regard to contingent payments to an estate, the regulations take opposite positions when valuing GRATs (where the IRS's interest lies in minimizing the annuity value) and charitable trusts (where it seeks to maximize the annuity).

As a result, the tax court threw out Example 5 of the regulation as "an unreasonable interpretation and an invalid extension of section 2702." No reduction in

[3] Example (5). A transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. The interest of A (and A's estate) to

the retained annuity was required for the possibility that Mrs. Walton could die during the GRAT term. The annuity value could equal or exceed the value of the stock, resulting in an insignificant taxable gift to Mrs. Walton. It is important to note, that the Walton case can still be appealed to the Court of Appeals for the Eighth Circuit, but given the length of time that has passed, such an appeal seems unlikely.

Keep a Short Annuity Term

It is generally best for a GRAT to have a short retained annuity term. For example a term of two years or three years is the ideal timeframe for a retained term in a GRAT. The reason for using a short annuity term is to take advantage of volatility in the value of the asset gifted to the GRAT and to minimize the mortality risk of the Settlor of the GRAT dying prior to the end of the GRAT annuity term. If there is a sharp increase in the market or in the value of an asset, the GRAT will end shortly thereafter, and thereby successfully capture such gain or appreciation in the continuing trust for the family beneficiaries. Conversely, if there is a downturn in the market or a value of an asset, the GRAT ends quickly and the Settlor can create a new GRAT at lower values using the assets received as an annuity payment. Thus, creating a GRAT with a longer annuity term can cause problems, since if an asset appreciates greatly and then decreases, the taxpayer has lost the opportunity to shift appreciation out of his estate. Additionally, a Settlor is more likely to survive two to three years than a longer length of time. If the Settlor does not survive the annuity term, the entire value of the GRAT is included in the Settlor's estate and there are no tax advantages for the Settlor.

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receive the unitrust amount for the specified term of 10 years in all events is a qualified unitrust interest for a term of 10 years.

However, it must be noted, that certain clients fund GRATs with assets for which they do not expect a significant return for several years. In such cases, and if mortality risk is less of a concern because of the age of the Settlor, and if the asset held by he GRAT will not appreciate for a longer time period, a longer GRAT term may make sense.

Separate GRATs for Separate Asset Classes

To further take advantage of market volatility and with a recognition that certain asset or asset classes have different return correlations, it is also important not to mix different assets or asset classes in one GRAT. Rather, it is important to be strategic about which asset classes are transferred to a GRAT. For, example, let's say Mr. Smith has two different types of asset classes he'd like to transfer to a GRAT. If he places both asset class #1 and asset class #2 in the same GRAT and asset class #1 appreciates greatly during the retained term and asset class #2 declines sharply during the retained term, the two asset classes will have canceled out any gain in the GRAT and wasted the estate and gift tax planning opportunity. If, however, instead Mr. Smith puts asset class #1 in one GRAT and asset class #2 in a different GRAT, the first GRAT will be successful and the second GRAT will simply fail. Using this segregated strategy, at least GRAT #1 will be successful and the appreciation from asset class #1 will be transferring out of Mr. Smith's estate tax free. We have many clients who set up multiple GRATs with a different asset class in each GRAT and they capture the success of an asset class and just re-GRAT any unsuccessful asset classes.

Many clients, if they have a diversified marketable securities portfolio may have in excess of ten GRATs per year. Typically, a client with investable assets wishing to maximize the amount they transfer to the GRAT beneficiaries, will create GRATs holding various asset classes. For instance, a client could have a separate micro cap, small cap, mid cap, and large cap domestic GRAT, in addition to a separate developed markets, emerging markets, and various bond GRATs.

To reduce the complexity of a large number of GRATs, at the end of the GRAT term for each set of GRATs, all successful GRATs can be merged into one continuing GRAT for the remainder beneficiaries, thereby reducing the number of trusts and reducing accounting and administrative fees.

Rolling GRATs

This type of steady GRAT program is often called a “rolling” GRAT program and works quite successfully, since basically at any given time a taxpayer’s investment assets are in a GRAT. Sooner or later the market for any particular asset class will take an upturn and that asset class’s GRAT will be successful. As annuity payments come out of a GRAT, they can simply be transferred into a new GRAT, and the process begins again. This steady process of maintaining a GRAT program and continually running a client’s investment portfolio through GRATs take a certain amount of diligence and organization. However, an extensive and steady GRAT program can provide wildly successful results for a taxpayer with relatively small risks and costs.

Formation of LLC to handle difficult to transfer assets

Sometimes a client wishes to transfer an asset or a class of assets that are difficult or time-consuming to transfer. In such a situation, the assets can be placed into a simple LLC structure. Then, instead of transferring the difficult to transfer asset into the GRAT and then out of the GRAT upon each annuity payment due date, the relevant LLC interests can be transferred in and out of the GRAT with simple LLC interest assignment documentation. Once the client is finished with his GRAT program, he can distribute all the assets out of the LLC and terminate the structure. There are some minimal costs to establishing the LLC, such as preparing the formation documentation and state filing fees. However, in certain situations, the ease of the LLC structure is worth such costs.

Even in cases where assets are not difficult to transfer, and LLC can often be helpful. For instance, if a client was putting his or her marketable securities portfolio into a series of GRATs, each investment classes could be put into an LLC. The investment advisor would invest the assets of each LLC. When annuity payments are due, the assets held in the LLC would be valued on the date of the asset transfer, and the LLC interest would be transferred to satisfy annuity payments and create additional GRATs. The advantage of such a structure is that the lawyer can handle the transfer and valuation of the LLC interest without relying on the investment advisor to continually value and transfer assets between trusts.

<u>Payment of annuity payment with cash first, and in kind assets second</u>

To maximize the potential growth of a GRAT, the GRAT should be structured such that the Trustee pays the annuity payment first with any cash that has accumulated in the GRAT and second with in kind assets.

In certain situations, if the client has sufficient liquidity in other trusts, the GRAT can borrow cash and/or marketable securities from one trust and use that cash or marketable securities to make the annuity payment. The client should not directly lend money to the GRAT to make the annuity payment as this is prohibited under the Regulations.

Payment of annuity more frequently than annually

Some clients have large closely held business but relatively small liquid portfolios. In certain cases, if a client receives only an annual annuity they will not have the required funds to pay taxes on trust income. As such, the annuity can be structured so that it is paid throughout the year as the GRAT receives distributions from the closely held business, with the balance of the annuity payment paid on the anniversary date of the GRAT.

GRATs funded with closely held businesses must continue to pay distributions pro rata

If a client funds a GRAT or multiple GRATs with a closely held business, care should be taken to continue to pay all distributions on a pro rata basis. As annuity payments are made, the ownership of the closely held business will change, and the formality of pro rata distributions is an important indicator in the case of an audit of the GRAT by the IRS that all formalities were respected.

III. Some Sample Calculations

Thus, to summarize, if the GRAT is structured so that the retained annuity's actuarial value is almost equal to the value of the property transferred, there is little gift tax consequence. If the taxpayer survives the annuity term, the appreciation on the assets transferred to the GRAT in excess of the section 7520 rate passes to the beneficiaries without any additional transfer tax.

Let's look at a sample calculation:

Mr. Smith transfers an investment portfolio equal to $1,000,000 to a GRAT and retains a right to an annuity for a term of 2 years. If the GRAT is funded in August of 2014, the

7520 Rate is 2.2%. The required annuity payment in Year 1 is 47.00573% and in Year 2 is 56.40687% of the initial $1,000,000 contribution to the GRAT.

Year	**Beginning Principal**	**5.00% Growth**	**Required Annuity Payments**	**Remainder**
1	$1,000,000.00	$50,000.00	$470,057.30	$579,942.70
2	$579,942.70	$28,997.14	$564,068.70	$44,871.14
Summary	$1,000,000.00	$78,997.14	$1,034,126.00	$44,871.14

Based on the above, the GRAT will remove $44,871.14 of growth from Mr. Smith's estate. Mr. Smith has not paid any gift tax or used any unified credit to transfer this $44,871.14 out of his estate.

Note, when funding a GRAT, if the asset is anything other than marketable securities, the asset should be valued by a licensed appraiser. If possible, discounts for lack of control and lack of marketability should be applied to the asset. If no such discounts are available, recapitalizations of closely held businesses into voting and nonvoting shares and a subsequent disposition of the voting interest should be explored, prior to valuing the asset and creation and funding of the GRAT.

IV. Governing Instrument Requirements of a GRAT.

When structuring and administering a GRAT for a client, a threshold administrative step is to make sure that the governing instrument meets the requirements of section 2702 so that the client's retained interest may be subtracted from the value of the transferred property in determining the client's gift to the remainder beneficiaries. If a GRAT instrument does not meet the requirements of section 2702, the client's retained interest is valued at zero and the gift made by the client to the remainder beneficiaries is the entire value of the trust assets, which is obviously a bad result.

Section 2702(b) defines a "qualified interest" to be:

1. Any interest which consists of the right to receive fixed amounts payable not less frequently than annually, and
2. Any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually).

In addition, the term of the annuity in a GRAT must be a fixed amount of time equal to the life of the annuitant, a specified term of years, or the shorter of those two periods. The GRAT trust instrument must require that the annuity amount be payable back to the taxpayer who created the GRAT, ie, the holder of the annuity interest, at least annually.[4] The annuity payment may be based on the taxable year of the trust or it may be based on the anniversary date of the trust.[5] If the payment is made on the anniversary date, proration of the annuity amount is required only if the last period during which the annuity is payable to the grantor is a period of less than 12 months. If the annuity payment is based on the taxable year, proration of the annuity amount is required for each short taxable year of the trust during the grantor's term. The prorated amount is the annual annuity amount multiplied by a fraction, the numerator of which is the number of days in the short period and the dominator of which is 365 (or 366 if the proration occurs

[4] Treas. Reg. § 25.2702-3(b)(1).
[5] Treas. Reg. § 25.2702-3(b)(3)

during a leap year).[6]

We generally create our GRATs to provide that the annuity will be paid annually, on the anniversary of the GRAT creation date. If a grantor's annuity payment is based on the anniversary date of the GRAT's creation date, it must be paid no later than 105 days after such anniversary date.[7] An annuity payment based on the taxable year of the trust may be paid in the subsequent year as long as the annuity is paid by the date on which the trustee must file the income tax return for the trust determined without regard to extensions.[8] The trust instrument must require that the trustee actually pay the annuity amount to or for the benefit of the grantor; i.e., it is not sufficient for the grantor to have the annual right to withdraw the annuity amount.[9]

It is important to consider the logistics of how the annuity payment is going to paid back to the creator of the GRAT. The annuity must be paid to the grantor regardless whether the trust has produced income equal to the annuity. If the GRAT has not produced enough income to pay an annuity payment, the GRAT's trustee must distribute principal to satisfy the annuity. Furthermore, a note, other debt instrument, option, or similar financial arrangement may not be used, directly or indirectly, to pay the annuity amount.[10] The GRAT's governing instrument should explicitly state the foregoing prohibition.

The annuity amount must be a fixed amount expressed either in the terms of a fixed dollar amount or a fixed percentage of initial fair market value of the property

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[6] Id.
[7] Treas. Reg. § 25.2702-3(b)(4)
[8] Id.
[9] Treas. Reg. § 25.2702-3(b)(1)(i)
[10] Treas. Reg. § 25.2702-3(b)(1)(i)

transferred to the trust as finally determined for federal tax purposes.[11] Under the IRS Regulations, the fixed amount does not have to be the same amount for each year. But, variations in the annuity amount from year to year may not exceed 120 percent of the amount payable in the previous year.[12] The Regulations require that the trust instrument contain a provision requiring adjustment to annuity payments previously made if an error was made by the trustee in determining the annuity amount.[13] In addition, the trust instrument must prohibit: (i) additional contributions to a GRAT[14] and (ii) commutation, or the prepayment by the trustee of the grantor's annuity interest.[15] The purpose of prohibiting commutation is to prevent termination of a GRAT when the grantor's life expectancy is short. If a taxpayer dies during the GRAT's term, the GRAT's assets will be included in the settlor's estate under Section 2036. This result could potentially be avoided if the trustee could terminate the GRAT before the settlor's death by paying the settlor an amount equal to the actuarial value of the settlor's remaining interest and delivering the balance of the trust assets to the remainder beneficiaries. The trust instrument must also prohibit: (i) payments from the trust before the expiration of the qualified interest to or for the benefit of any person other than the annuitant[16] and (ii) for trusts created on or after September 20, 1999, issuance of a note, other debt instrument, option, or similar financial arrangement in satisfaction of the annuity payment obligation.[17]

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[11] Treas. Reg. § 25.2702-3(b)(1)(ii)
[12] Id.
[13] Treas. Reg. § 25.2702-3(b)(2)
[14] Treas. Reg. § 25.2702-3(b)(5)
[15] Treas. Reg. § 25.2702-3(d)(4)
[16] Treas. Reg. § 25.2702-3(d)(2)
[17] Treas. Reg. § 25.2702-3(d)(5)(i)

V. Transfer Tax Aspects of GRATs.

Under section 2702(a)(2)(B), the value of a qualified annuity interest is determined under section 7520. Thus, the value of a gift to a GRAT will be determined by subtracting from the value of the assets transferred to the GRAT an amount equal to the actuarial value of the retained annuity. As already discussed, it is possible to structure the GRAT such that the value of the gift to a GRAT is essentially zero. A GRAT is a more attractive technique when the section 7520 rate is low, since the "hurdle" rate of appreciation that the assets transferred to the GRAT need to beat is lower. In addition, when using a zeroed out GRAT, a taxpayer can transfer difficult to value assets without a significant risk of unexpected gift tax, since the gift is going to be zero regardless of the valuation of the asset; it is only the value of the remainder interest that passes tax-free that is affected.

We recommend that a taxpayer always file a gift tax return to report a gift to a GRAT. It is always smart to run the statute of limitations on a gift to a GRAT, the valuation of the assets transferred to such GRAT and the effective administration of a GRAT. In addition, a timely filed gift tax return can be used to opt out of automatic GST exemption allocation to a GRAT at the close of an ETIP.

In addition, we recommend that as part of a GRAT's administration, careful records are kept documenting the payment of the annuity payments. Recently, we have received several audit requests from the IRS, requesting documented evidence that annuity payments were paid, and in the proper amount. The taxpayer should be advised of these audit risks and know that record-keeping is paramount.

Obtaining Marital Deduction for Annuity Payments if Taxpayer Dies During Annuity Term

If the grantor dies during the GRAT term, his or her estate planning documents should make sure to provide that the right to the remaining annuity payments passes to a surviving spouse, in order to ensure that the value of the remaining annuity interest qualifies for the estate tax marital deduction under section 2056. Thus, the grantor's estate planning documents should provide that if the grantor's spouse survives the grantor, the annuity payments will either (1) pass outright to the surviving spouse or her estate or (2) pass to a marital trust over which the spouse has a general power of appointment.

VI. GRATs and GST Considerations

For all of GRATs' well-deserved popularity, estate planners unfortunately seldom focus on the GST tax consequences of creating and administering a GRAT. Many advisors correctly understand that, generally speaking, GRATs might not be good vehicles for transferring wealth to "skip" persons (e.g., grandchildren and more remote descendants). However, those same advisors don't always understand that if you are not careful, you can run afoul of the GST automatic allocation rules and waste a taxpayer's precious and limited GST exemption.

Under Section 2642(f)(1), a taxpayer who creates a GRAT cannot effectively allocate GST exemption to the property transferred to such GRAT until the close of the estate tax inclusion period ("ETIP"). The ETIP is the period of time after a transfer during which the value of the property transferred would be includible in the transferor's gross estate. What this means is that the taxpayer cannot allocate GST exemption to the property transferred to the GRAT at the initial funding of the GRAT, but rather must wait until the GRAT annuity term ends to allocate GST exemption to the assets remaining in the GRAT at that time. However, it is vitally important to note that an estate planner administering a GRAT must pay strict attention to the close of the ETIP of a GRAT, because if the GRAT continues on into lifetime trusts for the taxpayer's family members in a trust that qualifies as a "GST Trust" under Section 2632(c)(3)(B) of the Code, there will be automatic allocation of GST to the assets remaining in the GRAT at the close of the ETIP. As with other transfers to GST Trusts, a taxpayer can elect out of automatic allocation to a transfer to a GST Trust under Section 2632(b) on a timely filed federal gift tax return. However, many estate planners do not focus on this automatic allocation nuance and do not address it, resulting in an automatic allocation of GST to a GRAT that has not been carefully considered. As with other transfers, once an automatic allocation of GST to a trust transfer happens, it cannot be revoked (other than via a successful private letter ruling request). Thus, taxpayers may end up with an inadvertent allocation of GST to a GRAT at the close of the ETIP.

The way to avoid an inadvertent automatic allocation of GST to a GRAT at the close of an ETIP is to file an election to opt out of such automatic allocation. For most clients, the more efficient approach to this situation is to opt out of automatic GST exemption allocation when filing the initial gift tax return reporting the gift to the GRAT. In most cases, this will be the desired result at the end of the ETIP, therefore eliminating the extra expense to the client of filing a second 709, or of forgetting to do so and wasting GST exemption. Of course, if allocation of GST exemption is desired, you can still file a second return and opt in at the close of the ETIP.