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A grantor retained annuity trust (GRAT) can be a very valuable estate planning technique, especially for rapidly appreciating assets. Properly designed, a GRAT can allow a grantor to “freeze” the value of an asset and keep some of the future appreciation out of the grantor’s gross estate. There are, however, several considerations in creating a GRAT.

STRUCTURE OF A *GRAT...*

To create a GRAT, the donor transfers assets to an irrevocable trust and retains an annuity interest for a specified number of years. At the end of the annuity term, the assets can remain in trust or pass to the trust beneficiaries. The present value of the remainder interest is a taxable gift upon creation of the GRAT. The amount of the gift depends on the length of the annuity term, the amount of the annuity, and the Section 7520 interest rate at the date of transfer. The IRS issues the Section 7520 rate monthly. Generally, it is advantageous to transfer assets to a GRAT when the 7520 rate is low. If the trust assets outperform this rate, the benefit will inure to the remainder beneficiaries.

◆ ***Requirements for the Annuity Interest***


The annuity must be a “qualified annuity interest,” which is an irrevocable right to receive a fixed amount. Treas. Reg. § 25.2702-3(b)(1)(i). The trust must make the annuity payments at least annually.



Treas. Reg. § 25.2702-3(b)(3). The GRAT agreement can describe the annuity interest as a fixed dollar amount or a percentage of the initial value of the trust assets as finally determined for gift tax purposes. Treas. Reg. § 25.2702-3(b)(1)(ii). If the grantor is uncertain about the value of the property transferred to the GRAT, the percentage option may be better because the annuity amount can increase if the IRS or the courts assign a higher gift tax value to the property. A GRAT may provide for annual variations in the annuity amount, provided the schedule of payments is fixed in the agreement and no annual payment is more than 120 percent of the previous year's payment. Treas. Reg. § 25.2702-3(b)(1)(ii). The trust can pay the annuity in cash or in kind. For example, if a grantor established a GRAT with corporate stock, the trust could make some of the annuity payments with shares of stock if there was insufficient cash. If the stock had appreciated in value, the trust could use fewer shares to make the annuity payments than the grantor transferred. The trust cannot use a promissory note or other debt instrument to make the annuity payments. Treas. Reg. § 25.2702-3(b)(1)(i).

◆ ***Length of the Annuity Term***

While a grantor can create a GRAT for the grantor's life or a term of years, selecting a lifetime GRAT will cause inclusion of the remainder in the grantor's estate. For this reason, a term of years GRAT is much more common. The term of years should be shorter than the grantor's life expectancy. As discussed below, if the grantor dies during the term of the trust, the value of the trust as of the date of death may be a part of the grantor's taxable estate.



The longer the term, the lower the value of the remainder because the annuity payments will consume more of the appreciation and current value of the assets.

◆ ***Other Rules***

The GRAT agreement must prohibit additional contributions to the trust. Treas. Reg. § 25.2702-3(b)(4). The trust agreement must also prohibit commutation or prepayment of the annuity term holder's interest. Treas. Reg. 25.2702-3(d)(4).

◆ ***Planning for the Grantor's Death During the Annuity Term***

As discussed below, if the grantor dies during the annuity term, some or all of the value of the trust may be includible in the grantor's taxable estate. There are several provisions the trust agreement may contain to address this possibility. First, the trust agreement can contain a contingent reversion clause that will return the trust assets to the donor's estate if the donor dies during the annuity term. The reversion cannot reduce the value of the taxable gift. Treas. Reg. § 25.2702-3(e), Ex. 1. The reversion can provide the estate with assets to pay the estate tax. Second, the trust agreement can contain a provision requiring the trustee to reimburse the executor of the grantor's estate for estate taxes paid on any part of the trust included in the grantor's taxable estate. An apportionment clause like this is a variation of a contingent reversion. As such, it will not reduce the value of the taxable gift. Third, the trust agreement can contain a clause providing that any amount included in the grantor's estate passes to the grantor's spouse in a manner that qualifies for the marital deduction.



INCOME TAX *Issues...*

A GRAT is a “grantor trust” during the annuity term because the grantor retains an annuity interest. I.R.C. §§ 673, 677(a); Weigl v. Commissioner, 84 T.C. 1192 (1985). This means the grantor must account for the trust’s income, gain, loss, deductions, and credits in computing the grantor’s personal income tax liability. I.R.C. § 671. The trust agreement can contain provisions that continue the grantor trust status of the trust even after the annuity term ends. The grantor trust status allows the grantor to effectively make an additional gift to the trust of the amount of tax attributable to trust income without incurring additional gift tax. The grantor trust status also means that the transactions between the GRAT and the grantor, such as the transfer of property or the annuity payments, are not taxable events. Rev. Rul. 85-13, 1985-1 C.B. 184.

A GRAT can hold S corporation stock during the annuity term because of the GRAT’s grantor trust status. I.R.C. § 1361(c)(2)(A). After the end of the annuity term, the GRAT becomes an ineligible shareholder, causing the corporation to lose its S corporation status, unless it remains a grantor trust or has language to qualify it as another type of trust that can hold S corporation stock.



GIFT TAX *Issues...*


◆ *Computing the Amount of the Gift*

Generally, if a grantor retains an interest in a trust established for the benefit of a member or members of the grantor's family, the value of the retained interest will be zero for gift tax purposes. I.R.C. § 2702(a). This means that the transferred interest will be worth the entire value of the property. There is an exception for any interest that is a "qualified interest." *Id.* The term "qualified interest" includes any interest that consists of the right to receive fixed amounts payable at least annually. I.R.C. § 2702(b)(1). Properly structured, the retained annuity payments in a GRAT fall under this definition of a qualified interest.

As noted above, one can compute the gift tax value of the GRAT remainder using IRS actuarial tables issued pursuant to Section 7520 of the Code. I.R.C. § 2702(a)(2)(B). The gift value depends on the length of the term and the amount of the Section 7520 rate at the date of transfer. The longer the annuity term, the lower the gift. Similarly, as the Section 7520 rate drops, so does the gift amount.


◆ *Zeroed-Out GRAT*

A popular variation of the GRAT is the so-called "zeroed-out" GRAT. Under this technique, there is no taxable gift because the grantor sets the annuity amount so high that the present value of the annuity payments equals the current value of the assets transferred. If the assets grow faster than the Section 7520 rate, there



may still be assets left in the trust at the end of the annuity term. This “unexpected” remainder passes free of gift tax. The IRS has taken the position that it is impossible to completely zero out the gift because one must account for the possibility that the grantor will die during the annuity term. Treas. Reg. § 25.2702-3(e), Ex. 5; P.L.R. 92-39-015 (June 25, 1992). However, the Tax Court has held that the IRS position on this issue is invalid if the trust must make the annuity payments to the annuitant’s estate after the annuitant’s death. Walton v. Commissioner, 115 T.C. 589 (2000). The court reasoned that an individual cannot make a gift to his or her own estate. The court also stated that the IRS position would effectively eliminate the term of years GRAT, a result not contemplated by Congress in Section 2702. In October 2003, the IRS finally acquiesced stating in Notice 2003-72, that it will follow the Tax Court’s decision in Walton, holding that Treas. Reg. § 25.2702-3(e), Ex. 5, of the Gift Tax Regulations is invalid. However, in Technical Advice Memorandum 200245053, issued after Walton but before the IRS announced its acquiescence in that case, the IRS stated the remainder in a GRAT could not be very small (like one percent). The TAM coupled with the fact that the IRS will not issue a Private Letter ruling on a GRAT which has a remainder interest of less than 10 percent has led some advisors to believe that the courts might agree with the conclusion in the TAM and that you should totally zero-out a GRAT.

Many clients may choose not to “zero out” a GRAT because the retained income stream required may bring too much back into the estate. In prior years, many “zeroed out” because they had



exhausted their lifetime exemption. In 2011 and 2012, clients have the opportunity to use GRATS to transfer substantial amount of wealth without “zeroing out.”

THE TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION *Act of 2010...*

The *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act* (“the Act”) was enacted on December 17, 2010. For 2011 and 2012, the Act provides for a \$5 million Federal gift, estate and generation skipping transfer tax exemption amount (indexed for inflation starting in 2012) and a top gift, estate and GST tax rate of 35%. On January 1, 2013, a \$1 million Federal gift, estate and GST exemption amount and a maximum gift, estate and GST tax rate of 55% is scheduled to go into effect. These considerations apply only to the Federal transfer taxes. Any state-level estate or inheritance tax should be evaluated separately.

Taxable gifts may be more attractive in 2011 and 2012 because the amount of tax payable may increase in future years due to these changes in the estate and gift taxes. However, as noted above, one can structure a GRAT to incur very little or no gift tax. Thus, a GRAT may still be a valuable planning technique even as the estate tax phases out and the gift tax rates drop.




OTHER GIFT TAX *Issues...*

A grantor and his or her spouse can elect to split the gift to the trust. I.R.C. § 2513. This enables the spouse to use his or her unified credit and the lower gift tax brackets. The drawback to this is that if the grantor dies during the annuity term, causing inclusion in the grantor's estate, the spouse cannot recover his or her unified credit or the advantage of the lower brackets. Additionally, gifts to a GRAT do not qualify for the annual exclusion because they constitute gifts of future interests.

ESTATE TAX *Issues...*

There had been conflicting views about how much of the GRAT assets are includible in the grantor's estate if the grantor dies during the annuity term. In the past the IRS took the position that IRC 2039 might apply instead of IRC section 2036. If section 2039 applied then entire value of the trust would be included in the estate; whereas, if section 2036 applied a lesser amount could be included in the estate. The IRS clarified its position by issuing proposed regulations in 2007 stating that 2036 would apply instead of 2039. These proposed regulations provided that the portion of the trust that would be includable in the decedent's gross estate is that portion of the corpus valued at the



decedent's death, necessary to yield the annual payment required under the GRAT using the appropriate 7520 interest rate. Based on the examples in the proposed regulations, if long-term GRAT assets have significantly appreciated, there will be a substantial tax free transfer of wealth, even if the grantor dies during the GRAT term. If, however, you have a short term zeroed-out GRAT and death occurs before the end of the term, it is likely that all the assets in the GRAT will be included in the grantor's estate.

ADVANCED GRAT *Planning...*

◆ *Rolling Zeroed-Out GRATs*

An extension of the zeroed-out GRAT concept is the idea of “rolling” zeroed-out GRATs. Under this approach, the grantor establishes a series of successive two-year zeroed-out GRATs, using the annuity payments from one GRAT to fund the next one. The short term reduces the risk of the grantor dying during the GRAT term and the risk of the asset crashing in later years of the GRAT. Typically, the GRAT will be invested in volatile vehicle and any growth that exceeds 7520 rate will pass to the remainder beneficiary. If those assets don't exceed the 7520 rate, nothing is lost because they just return to the grantor who then funds another two year GRAT. If this strategy is followed over a long period, it is possible to pass significant appreciation to the remainder beneficiaries with no gift tax cost.



◆ ***One Asset GRATs***


Setting up multiple GRATs and funding each GRAT with only one asset rather than using one large GRAT can be advantageous. Strong assets do not have to compensate for poor performing assets. For example, an owner of a 100-acre parcel of land with potential oil reserves could set up 100 zeroed-out GRATs, consisting of one acre each, prior to drilling. The non-producing acres would come back to the grantor and the producing areas would generate a windfall for the grantor's children. The one asset GRAT is often combined with the zeroed-out rolling GRAT to provide the most amount to the remainder beneficiaries.

◆ ***Super GRATs***

The "super GRAT" is a GRAT funded with discounted assets, such as limited partner interests in a family limited partnership (FLP). The discount reduces the initial taxable gift and allows the annuity amount to be smaller.

COMPARISON OF GRAT TO IDIT *Sale...*

Another popular estate planning technique for appreciating assets is for the grantor to sell the assets to an intentionally defective irrevocable trust (IDIT). An IDIT is an irrevocable trust designed to be a grantor trust for income tax purposes. In a typical transaction, the grantor will sell assets to the IDIT in exchange for a promissory note




from the IDIT. The note bears interest at the applicable federal rate (AFR) issued by the IRS for the month of the sale. One can structure an IDIT sale to look very much like a GRAT by adjusting the term of the note to match the GRAT annuity term and the amount of the note payments to match the GRAT annuity payments. There are several factors to consider in comparing an IDIT sale to a GRAT including: (1) the assumed discount rate; (2) the risk of inclusion of trust assets in the grantor's estate; (3) the ability to allocate generation skipping transfer tax (GSTT) exemption; (4) the ability to "end-load" the payments from the trust; (5) the ability to totally zero out the gift tax value of the transaction; (6) the ability to adjust the payments in the event the IRS or the courts assign a higher value to the assets; (7) the risk of an IRS argument under Section 2702 of the Code; and (8) the relative tax certainty of the GRAT transaction.

◆ ***Assumed Discount Rate***

As noted above, the IDIT note must bear interest at the applicable federal rate (AFR). By contrast, one calculates the GRAT remainder using the Section 7520 rate. The Section 7520 rate equals 120 percent of the federal midterm AFR. An IDIT note that falls into the "midterm" category (more than three but less than nine years) need only bear interest at 100 percent of the midterm AFR. A longer term note must use the long-term AFR, but this rate is still usually lower than the Section 7520 rate.

◆ ***Risk of Inclusion of Trust in Grantor's Estate***

If the grantor of a GRAT dies during the annuity term, the portion of the trust is includable in the Grantor's gross estate. Is that portion of the Grantor's trust corpus, valued at the death, necessary




to yield the annual payout under the GRAT using the appropriate 7520 interest rate. An IDIT sale transaction may involve some risk of inclusion if the grantor dies while the note is outstanding. Proper drafting and planning may enable the grantor to avoid some of these risks of inclusion in an IDIT sale transaction. Also, if the IDIT satisfies the note prior to the grantor's death, the risk of inclusion may lessen.

◆ ***Allocation of GSTT Exemption***

One cannot allocate GSTT exemption to a transfer during any "estate tax inclusion period" (ETIP). I.R.C. § 2642(f)(1). An ETIP is any period after the transfer during which the property would be included in the grantor's estate for estate tax purposes if the transferor died. I.R.C. § 2642(f)(3). The annuity term of a GRAT is an ETIP, meaning the grantor cannot allocate GSTT exemption to the trust until the end of the annuity term or the grantor's death, whichever comes first. This means that appreciation during the annuity term does not escape the GSTT as it does the gift and estate tax. In an IDIT, there is arguably no ETIP because the IDIT arguably avoids inclusion of the trust assets in the grantor's estate irrespective of the year of death. Note that The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 temporarily set the GSTT exemption at \$5,000,000 for 2011 and 2012 with a rate of 35%, reverting back to \$1,000,000 in 2013.

◆ ***End-Loading Payments from Trust***

As discussed above, the terms of the GRAT instrument can vary the amount of the annuity payments, but no annual payment can be greater than 120 percent of the previous year's payment. Treas.



Reg. § 25.2702-3(b)(1)(ii). This effectively prevents “end-loading” the GRAT by making smaller payments in the initial years and a large lump sum in the final year. By contrast, an IDIT note can provide for interest only for a period of years with a balloon payment of principal at the end of the note term. This allows the parties to keep the maximum amount of appreciation in the trust during the note term.


◆ ***Ability to Completely Zero Out Gift***

IRS regulations and rulings seem to suggest that it is impossible to completely zero out the gift tax value of a GRAT because of the possibility that the grantor will die during the annuity term. Treas. Reg. § 25.2702-3(c), Ex. 5; P.L.R. 92-39-015 (June 25, 1992). As discussed above, the Tax Court has ruled against the IRS on this issue. Walton v. Commissioner, 115 T.C. 589 (2000).

In an IDIT sale transaction, the parties typically make the note amount equal the fair market value of the assets transferred. In this way, there is no gift because the trust is paying fair market value for the assets. A grantor may, however, wish to make a “seed gift” to the IDIT to avoid an IRS argument that the arrangement is really a gift with a retained interest. The seed gift would, of course, be subject to gift tax.

◆ ***Adjustment of Transaction to Reflect Increased Value***

In some cases, the IRS or the courts could assign a higher value to assets transferred to a GRAT or IDIT. IRS regulations specifically allow a GRAT instrument to express the annuity amount as a percentage of the initial value of the assets transferred as finally



determined for gift tax purposes. Treas. Reg. § 25.2702-3(b)(1)(ii). This allows an adjustment to the annuity amount if the IRS or the courts assign a new value. It is not certain if the IRS or the courts would respect an adjustment clause in an IDIT sale document or note. This could result in an unexpected taxable gift.

◆ ***Risk of Section 2702 Argument***

The IRS could attack an IDIT transaction by recharacterizing the transaction as a gift to a trust with a retained income interest. The IRS could then invoke Section 2702 of the Code to ignore some or all of the note payments in calculating the value of the deemed gift to the trust. By contrast, a grantor's retained annuity interest in a GRAT is a "qualified interest" under Section 2702 if the GRAT meets the requirements set out in IRS regulations. This means that the grantor can use the actuarial value of the retained interest to reduce the amount of the taxable gift to the remainder beneficiaries.

◆ ***Relative Tax Certainty of the GRAT Transaction***

As discussed above, the IDIT sale involves numerous tax issues, the resolution of which is uncertain. There are very few court decisions and IRS rulings that deal with an IDIT sale. A GRAT, by contrast, is a fairly well established planning technique. The Code and the associated IRS regulations set out the rules for creating a GRAT. IRS rulings and court decisions have resolved many of the other issues surrounding the GRAT transaction. A person who desires more certainty as to the tax treatment of a planning technique may be more inclined to create a GRAT instead of selling assets to an IDIT.



Conclusion...

A GRAT can be a useful planning technique for assets growing faster than the Section 7520 rate. The grantor can transfer the future appreciation above the Section 7520 rate to the heirs at little or no gift tax cost. A drawback is that some or all of the trust assets may be includible in the grantor's estate if the grantor dies during the annuity term. Anyone considering a GRAT should consult with his or her own legal and tax advisors regarding the issues involved.



Grantor

Grantor transfers property to a trust.

Grantor receives payment for term of years or life.

The taxable gift is the difference between the value transferred and the present value of the retained payment stream.

Note: If the grantor dies during the fixed term, the trust will be subject to estate tax.

Grantor transfers asset



Grantor receives payment



Grantor Retained Annuity Trust (GRAT)

Trust receives assets from grantor.

Trust pays grantor a stated periodic payment over a term of years, or life.

At the expiration of the fixed term, trust may pay out balance to beneficiaries or stay in effect to manage distributions to them.


Balance to beneficiaries



Beneficiaries

The beneficiaries receive distributions from the trust, either outright, or according to the terms of the trust document.

A GRAT is a way to shift appreciation of assets out of the taxable estate, while minimizing gift tax effects and retaining an income stream.



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