<u>PART II</u>
GRANTOR RETAINED ANNUITY TRUST
(GRAT)

By

Leo J. Cushing, Esq., CPA, LLM
Cushing & Dolan, P.C.
Attorneys at Law
375 Totten Pond Road, Suite 200
Waltham, MA 02451

I. DESCRIPTION OF TECHNIQUE

Donor transfers the property into a trust reserving the right to be paid an annuity every year until the term of the GRAT ends. The technique is governed by IRC § 2702, which was enacted in 1990 as part of Chapter 14 to eliminate a perceived abuse with grantor retained Income Trusts, in which property was given away and a "retained income interest" is retained, but no amounts were actually paid to the grantor.

- IRC § 2702 forces the use of an annuity rather than merely an income interest creating a special valuation rule.
- IRC § 2702(a) provides that the value of the retained interest shall be zero unless the retained interest is a qualified interest.
- A qualified interest is where a fixed annuity or a "unitrust" amount that must be paid every year. IRC § 2702(b)

This section does not apply to transfers between nieces and nephews, but only to transfers between family members defined as the Donor's spouse, ancestors and lineal descendants of the Donor and the Donor's spouse, and siblings of the Donor and their spouses (but not children of siblings). IRC § 2702(e) referring to IRC § 2704(c)(2).

II. EXAMPLE

Assume a $10,000,000 asset. The grantor is age 60. The grantor is considering a 10 year GRAT.

May, 2011, IRC § 7520 Rate = 3.00% (120% Federal Mid-term AFR Rate). IRC § 2702(a)(2)(B)

FAIR MARKET VALUE	GRAT	GRIT
Fair market Value	$10,000,000	$10,000,000
Annual Annuity	$ 1,000,000	$ 0
Present value of Annuity Payments	$8,530,200	n/a
Gift	$1,469,800	$6,353,500

III. GRAT

ADVANTAGES

- The value of the gift can be zeroed out following the case of ***Walton v. Commissioner***, 115 T.C. 41 (2000). In *Walton*, Walmart stock worth $100,000,000 was transferred to a two-year GRAT with the first payment equal to $49,350,000 and the second annual payment in the amount of $59,220,000 for a total of $108,570,000. The value of the stock declined so that none of the wealth was transferred to the trust beneficiary at the end of the two year term. Even though no benefit was realized, the IRS assessed a taxable gift of $3,822,000 consisting of the Estate's contingent interest of $2,938,000 and the remainder interest $838,522. The Tax Court ruled in favor of the taxpayer.

- The amount of the gift can be adjusted by increasing the term of the retained interest or the amount of the annuity. In the prior example, an annuity for ten years of $1,249,328 would zero out the GRAT

- The valuation risk in a uni-trust can be eliminated in a GRAT since the amount of the annuity will adjust automatically if there is a valuation adjustment. Reg. 25.2702-3(c)(2)

DISADVANTAGES

- The full value of the property transferred to the trust will be included in the grantor's estate if the grantor dies during the term. IRC § 2036(c); Regs. 20.2036-1(c)(2)

- The GRAT is not an effective generation skipping transfer technique since generation skipping transfer tax exemption cannot be allocated until the closing of the so-called estate tax inclusion period (ETIP), per section Regs. 25.2632-1(c)(3). (Any allocation of GST exemption to such property cannot be made before the close of the estate tax inclusion. IRC § 2642(f)(1).)

This means that in the case of the 10 year $10,000,000 GRAT, the value of the gift currently is $1,469,800, but if the property appreciates to $20,000,000 in 10 years and then is paid to grandchildren, a generation skipping tax will be imposed to the extent the transfer exceeds the generation skipping transfer tax exemption.

Example:	FMV	$20,000,000
	Less GST Exemption	$ 5,000,000
	Taxable GST Termination	$15,000,000
	GST Tax (35%)	$ 5,250,000

- The Donor (and no one else) is entitled to the Annuity during the term. Regs. 25.2702-3(d)(3)
- Additional contributions to the GRAT must be prohibited. Regs. 25.2702-3(b)(5)
- Commutation of the term interest must be prohibited. Regs. 25.2702-3(d)(4)
- Cannot use a Note or other debt interest to pay the annuity. Regs. 25.2702-3(d)(6)

See *Simches v. Simches*, 423 Mass 683 (1996) (A Massachusetts case in which a reformation proceeding permitted to change a QPRT remainder beneficiaries from grandchildren to children.)

PLANNING NOTE
In order to minimize mortality risks and to affect market conditions, a series of two-year GRATs usually will be recommended instead of a single ten-year type term GRAT.

- Multiple GRATs require ongoing significant legal fees each year.
- The property subject to the GRAT must be valued each year if the income generated from the property is not sufficient to pay the annuity amount.

PLANNING NOTE
A GRAT will be an intentionally defective grantor trust so that the use of an asset to pay the annuity will not be considered a capital gain transaction. It is a transaction between the grantor and a grantor trust. Rev. Rul. 85-13

OTHER CONSIDERATIONS

- As a grantor trust, the grantor is taxed on the income generated by the GRAT.
- A GRAT is permissible with discounted assets.

- To be successful, the rate of return must exceed the IRC § 7520 rate. (3% for the month of May, 2011)

IV. SALE OF ASSETS TO AN INTENTIONALLY DEFECTIVE IRREVOCABLE GRANTOR TRUST

SUMMARY OF TRANSACTION

- Grantor establishes an irrevocable trust that is excluded from the estate for estate tax purposes.

- Income and principal may be payable to Donor's spouse and issue in trustee's discretion during the term.

- The trust can, and should be, set up for perpetuity or at least as long as the applicable estate law of perpetuities permits.

- The trust is a grantor trust for income tax purposes by including the power of substitution under IRC § 675(4)(C), which provides: "The grantor shall have the right to reacquire trust corpus by substituting property of an equivalent value."

PLANNING NOTE
The provision has been approved by the Internal Revenue Service in connection with an intentionally defective trust where the IRS ruled that such a clause would not cause the trust assets to be includible in the decedent's estate under IRC § 2038 and IRC § 2041. Rev. Rul. 2008-22.

PLANNING NOTE
Some commentators do not wish to rely on this provision if the trust itself will hold life insurance since the IRS did not answer the question about incidents of ownership.

- If working with an S corporation, recapitalize the S corporation with voting and nonvoting shares in a 9 to 1 nonvoting stock dividend.

- Determine the value of the nonvoting shares by taking into account applicable discounts for lack of marketability and lack of control.

PLANNING NOTE
If possible, work with Limited Liability Companies and Limited Partnerships to avoid any built in gain problem or possible gain on the distribution of appreciated property from the company to its owners. See, IRC § 311(b), which provides: that the distribution of appreciated property from a corporation (including an S corporation) will be considered a sale for fair market value and a distribution of the proceeds.

- Fund/Seed the trust with an amount equal to 10% above the assets being purchased." (There is no statutory or regulatory basis for this, but seems to be an accepted standard.) See, Petter v. Comm., T.C. Memo. 2009-280 (Defined value formula permitted in a case where 10% seed money was used.)

PLANNING NOTE

With a $5,000,000 lifetime giving exemption, this could equate to a sale of $50,000,000 in stock. This would be the equivalent of an $80,000,000 company on a discounted basis.

- Determine whether to use one of the following techniques:

  (1) an installment note (FMV of Note included in Donor's estate)

  (2) a self-cancelling installment note see, *Frane v. Comm.*, 998 F.2d 567 (8th Cir. 1993) (FMV of Note not included in Donor's estate.)

  (3) a private life annuity See, GCM 39503; Rev. Rul. 86-72

- Determine applicable interest rate using applicable federal rate, which is as follows for the month of May:

Term	Applicable Rate
3 years or less	federal short term rate
4 to 9 years	federal midterm rate
9 years or greater	long term rate

  See, *Frazee v. Comm.*, 98 T.C. 554 (1992)

  IRC § 1374(d)

- Prepare amortization schedule and be sure cash flow from enterprise is sufficient to pay the principal.

- Obtain solid valuation and to minimize valuation adjustments, consider using a formula purchase price. See, *Petter v. Comm.*, T.C. Memo. 2009-280 (The Donor gifted to a trust as seed money before the sale of LLC units equal to 10% of the value of the total units held in the trust after the sale.) See, also, *Knight v. Comm.*, 115 T.C. 506 (2000) (A gift was made to children in an amount equal to those number of FLP units having a value of $300,000.); *McCord v. Comm.*, 461 F.3d. 614 (5th Cir. 2006); *Estate of Christiensen*, 586 F.2d. 1061 (8th Cir. 2009) Aff'g. 130 T.C. (Formula value allocations between trusts permitted.)

- Avoid IRC § 2036 problems by having automatic wire transfers to make a distribution of funds to the owners and then a corresponding payment of the promissory note by the trust.

- The payment of principal which would otherwise be subject to the capital gain to the grantor is taxable since the transaction is between a grantor and a grantor trust. Rev. Rul. 85-13

- The payment of interest is not taxable to the grantor even though it is a transaction between a grantor and a grantor trust. Rev. Rul. 85-13

- The grantor must pay the income taxes attributable to the income allocated to the IDGT. Rev. Rul. 2004-64

PLANNING NOTE
Revenue Ruling 2004-64 provides that the independent trustee can reimburse the grantor each and every year for his or her incremental income tax.

- If income from the enterprise is insufficient to pay the annuity, then consider using either membership interests or S corporation shares to pay amounts due under the note.

- Consider distributing low basis appreciated assets from the enterprise (at least in the case of a partnership) to the trust, which can be used to repay the note on a non-discounted basis.

PLANNING NOTE
This will not work in the case of an S corporation because of Code Section 311(b). The trust's basis is a carryover basis since no taxable gain was recognized at the time of the sale. Consider using a self-cancelling installment note or a private annuity.

- An installment note is not a retained interest subject to IRC § 2702. PLR 9535026 and PLR 9436006

V. SELF-CANCELLING INSTALLMENT NOTE

- No amount attributable to the note is includible in the decedent's estate.

- At the time of the sale, a premium must be built in to either the interest rate or the principal payment. (This could be a disadvantage if death does not occur within the anticipated term.)

VI. PRIVATE ANNUITY

- Use IRC § 7520 rate to determine the appropriate annuity to avoid excess gift.

- No amount is includible in the decedent's estate upon death since the private annuity terminates and no portion of it passes to any other person.

VII. INCOME TAX CONSEQUENCES ON TERMINATION OF GRANTOR STATUS UNCERTAIN

- In the Estate of Frane, the promissory note in question was between the settlor and an individual so that, while no amount was included in the decedent's estate, the amount of the deferred gain was recognized on death and became taxable to the estate as part of the fiduciary income tax return.

- The same rule would apply in the case of a regular note.

- In the case of a sale to an intentionally defective trust, there is no specific authority.

PLANNING NOTE
There is no dispositive authority indicating how the termination of grantor trust status should be treated where, at that time, the trust continues to owe a debt to the grantor. In Reg. 1.1001-2(c), Example 5, the grantor is required to recognize a gain because the property held in trust at the time grantor trust status terminates is encumbered by a debt owed to a third party (not the grantor) that exceeds the grantor's basis in the assets. Clearly, the example was designed to confirm the result in Madorin, 84 TC 667 (1985), and Rev. Rul. 77-402, 1977-2 CB 222, in order to prevent tax payers owning a "burnt out" tax shelter from disposing of it without recognizing the "recapture" income.

Similarly, in TAM 200011005 (which, of course, is not precedential authority), at the time grantor trust status terminated, the trust owes a debt to a third party. And, unlike Example 5, the debt did not arise in a tax-shelter context, but rather as a result of a loan taken by the trustee. The IRS concluded that the transaction was "substantially similar" to the one posited in Example 5 and that, as a result, the grantor had to recognize gain on the excess of the debt over basis. However, in neither Example 5 nor the TAM is the debt owed to the grantor. Thus no authority clearly determines the treatment of the grantor in connection with the trust's debt to the grantor where grantor trust status terminates during the grantor's life.

PLANNING NOTE
Try to pay the note off before death.

VIII. CONSIDER USING A DOMESTIC ASSET PROTECTION TRUST

- In most states, the settlor cannot be a beneficiary, otherwise the assets in the trust are included in the decedent's estate. *Ware v. Gulda*, 331 Mass. 68 (1954); *State Street Bank & Trust Company v. Reiser*, 7 Mass. App. 663 (1979); Rev. Rul. 76-103; Rev. Rul. 77-378

- Generation skipping transfer exemption can be allocated at the time of the sale and the trust will forever be free of generation skipping transfer and can last literally forever.

- In connection with paying the annuity, amounts under the trust will include children, grandchildren, and great-grandchildren, and will automatically be added as new members arrive, all of whom would be eligible for the annual exclusion gifts.

- Consider using annual exclusion gift to forgive the note and reducing the amount that needs to be paid back to the grantor by including Crummey trust provisions.

PLANNING NOTE
Crummey withdrawal powers does not change from the grantor to the beneficiaries under IRC § 678(a) by virtue of IRC § 678(b)

- Consider using a state which has repealed the self-settled rule, such as New Hampshire, Rhode Island, or Delaware (and also repealed the rule of perpetuities).

- Such a trust requires that the trustee be a resident of the applicable state.

- All statutes also allow the appointment of a trust advisor who is responsible for telling the trustee where to invest the assets (and when and if to make distributions).

IX. INCOME TAX REPORTING PRIOR TO AND AFTER GRANTOR'S DEATH

- The trust does not pay any income taxes and merely fills out Form 1041 identifying it as a grantor trust and sending a tax letter to the grantor advising the grantor to include the items of income, deduction, and credit on his or her personal income tax return.

- After death, the trust will become a complex trust, with income taxable to the trust unless income is distributed under the income distribution rules of IRC § 661 and IRC § 662.

- If the irrevocable trust owns S corporation stock, be sure to monitor the period to avoid an inadvertent termination of the S election.

- IRC § 1361(c)(2)(A)(ii) provides that for the first two years after death, since the trust was considered wholly owned by the grantor, it remains an eligible S corporation shareholder.

- Thereafter, it must convert to either a qualified subchapter S trust or to an electing small business trust. (ESBT)

- It is unlikely that the trust is eligible as a qualified subchapter S trust since it can only have one income beneficiary and where it will likely default to an electing small business trust. See, IRC § 1361(d).

- As an ESBT, a separate sub-share is effectively created within the irrevocable trust to hold the S corporation shares.

- A new identification number will be issued relative to such share.

- In computing taxable income of the trust, the income distribution rules do not apply and all income attributable to the S corporation will be taxed at the highest applicable federal rate.

PLANNING NOTE
Funds actually distributed from the S corporation will be consolidated with the remaining trust assets, which will be subject to the usual fiduciary income tax rules (i.e., taxable to the trust unless money is actually distributed from the trust to a beneficiary).

X. SAMPLE INCOME TAX COMPLIANCE

(Form 1041 – before Death)
(Form 1041 – after Death)

XI. QUALIFIED PERSONAL RESIDENCE TRUST (QPRT v. HOME SECURITY TRUST

INTRODUCTION TO QPRT

- This is similar to the GRAT, but no amount is required to be paid pursuant to the terms of the QPRT. Regs. 25.2702(5)(c)

- This is an exception to the IRC § 2702 rules for a home and a second home.

- Very ineffective for allocation of generation skipping transfer tax exemption since the ETIP rules apply. IRC § 2642(f)(3), (4); Reg. 26.2632-1(c)(2)

- Ineffective if the property has a mortgage since the payment of mortgage represents an addition to the trust.

- No step-up for GST purposes in the case of a child who dies after creation of the trust since the "deceased parent exception" is measured at the time the gift is complete.

- The property will be included in the Donor's estate if the Donor dies during the term of the trust. IRC § 2036(a)(1)

- The QPRT (and any residual grantor trust) must prohibit the reacquisition of the property by the Donor. Regs. 25.2702-5(c)(9)

INTRODUCTION TO HOME SECURITY TRUST

- As an alternative consider transferring outright over a number of years the property to an irrevocable intentionally defective grantor trust using Crummey withdrawal notices.

- If the value of the property exceeds $5,000,000, have the grantor take back a promissory note.

- The property must be rented by the grantor for fair rent in order to avoid estate tax inclusion.

- The payment of rent to the IDGT is income tax free.

- The receipt of payments under the installment note are income tax free.

- The trust takes a carryover basis so consider having the grantor repurchase the property before death for cash so the decedent dies with low basis property to take advantage of a step up in basis.

PLANNING NOTE:
This provision is so important that it is prohibited to be included in the terms of a qualified personal residence trust or in any trust into which the property flows after the termination of the qualified personal residence trust.