Overview of Grantor Retained Annuity Trusts

A grantor retained annuity trust ("GRAT") provides the grantor with a "qualified annuity interest," which is the right to receive a fixed amount, payable at least annually. IRC § 2702(b)(1). Because the annuity is a "qualified interest," the value of the grantor's retained interest is valued under IRC § 7520, and the value of the gift will be the fair market value of the property transferred less the present value of the retained annuity interest determined under IRC § 7520.

Overview of Grantor Retained Annuity Trusts

A GRAT is an irrevocable trust that pays the grantor an annuity, at least annually, for a fixed term of years. The annuity interest generally is described as a percentage of the initial value of the assets transferred to the GRAT. If the grantor is living at the end of the term, any property remaining in the GRAT after the last annuity payment is made will pass to the remainder beneficiaries (usually the grantor's children), either outright or in trust for their benefit. If the expected return on the GRAT assets is less than the applicable IRC § 7520 rate, all of the trust property will be distributed to the grantor as part of the annuity payments during the trust term and nothing will be left for distribution to the remainder beneficiaries. The grantor will be no worse off than if the grantor had not created the GRAT, except for the cost of creating the GRAT and any gift tax paid upon funding the GRAT. If the return exceeds the applicable IRC § 7520 rate, however, then the remaining trust property will be distributed tax free to the remainder beneficiaries. If the GRAT is appropriately designed and the assets appreciate significantly, substantial wealth can be transferred to the grantor's children free of both gift tax and estate tax.

EXAMPLE 1: Grantor, age 50, transfers $1,000,000 to a 5-year GRAT. The IRC § 7520 rate is 5.4%. The annual annuity payment to Grantor is $233,535.60. If the assets grow at the rate of 5%, all of the assets will be distributed to Grantor to satisfy the annuity, and no property will be left in the GRAT at the end of the term.

EXAMPLE 2: The facts are the same as in Example 1, except that the assets grow at the rate of 8%. Because the return on the assets exceeds the IRC § 7520 rate, there will be assets in the GRAT at the end of the term to be distributed to the beneficiaries. At an 8% return, $99,267.90 will be left for the beneficiaries.

Generally, any assets with appreciation potential or total return in excess of the IRC § 7520 rate are appropriate assets for a GRAT. Assets that can be valued at a discount, such as a minority interest in a closely held corporation, a limited partnership interest or a large block in a publicly traded company, can produce significant savings because the amount of the annuity will be based on the discounted value of the asset, rather than on the full value. In this situation, the grantor's annuity payments (which are potentially includable in the grantor's estate) will be smaller than if the annuity payments were based on assets that were not discounted. This will be particularly beneficial if the asset has a high yield because the effective yield will be made even higher by the discount. Additional benefits can be obtained if the asset can be valued at its full value (rather than its discounted value) when distributed as part of the annuity payment or to the remainder beneficiaries at the end of the GRAT term. The latter circumstance can occur, for example, when a GRAT holds limited partnership interests and distributes such interests tax-free to the remainder beneficiaries upon the end of the GRAT term. If the remainder beneficiaries can then terminate the limited partnership, they will receive the undiscounted assets from the limited partnership with no tax consequences.

➔ **Planning Point:** If the assets in the GRAT have significant appreciation, the grantor may be able to substitute other assets to "lock-in" the profit of the GRAT. This may be appropriate when the highly-appreciated assets currently held by the GRAT are nonetheless volatile, and the assets substituted will still appreciate but with less volatility. This substitution may be prohibited, however, by Treas. Reg. § 25.2702-3(b)(5), which requires the GRAT instrument to prohibit additional contributions after the initial funding. A number of private letter rulings have approved GRAT instruments containing a power of substitution without mentioning this issue. See, e.g., PLR 200220014; PLR 200030010; PLR 9352007.

Gift, Estate and Income Tax Consequences

Gift Tax. The transfer of assets to a GRAT is a taxable gift. The amount of the gift will equal the excess of (a) the value of the property transferred to the GRAT over (b) the value of the interest retained by the grantor, determined under the actuarial tables in IRC § 7520.

> **EXAMPLE:** Grantor, age 50, transfers $5,000,000 to a GRAT with a 5-year term. The GRAT assets increase in value at a rate of 15% per year during the GRAT term. The IRC § 7520 rate in effect at the creation of the GRAT is 6%.
>
> The trust provides that Grantor will receive $1,186,972 from the GRAT each year during the 5-year term. The value of the annuity is $4,935,071. The amount of the taxable gift equals $64,929, which is $5,000,000 less $4,935,071, the value of the retained annuity. The assets remaining in the GRAT at the end of the 5-year term will, based on the stated assumptions, equal $2,053,772 and are distributable to children free of gift or estate tax. Thus, Grantor has transferred over $2,000,000 of assets to his children with a taxable gift of only $64,929.

➔ **Planning Point:** The gift made on the creation of a GRAT is a gift of a future interest. Therefore, it will not qualify for the gift tax annual exclusion. Gift tax will not be due, however, if the gift is sheltered by the grantor's applicable exclusion amount.

➔ **<u>Planning Point</u>:** The annuity rate and the length of the term can be adjusted so that the value of the initial gift is close to zero, so that no gift will result upon funding the GRAT. This type of GRAT is known as a "zeroed-out GRAT" and is accomplished by making the annuity large enough to have the value of the retained annuity interest equal the value of the property transferred, thereby reducing the value of the gift to zero. With a zeroed-out GRAT, the grantor will receive back all of the original assets transferred to the trust and some appreciation in the value of the trust assets, while shifting the appreciation in excess of the IRC § 7520 rate during the term of the GRAT to the beneficiaries. Zeroed-out GRATs will be discussed in detail below.

<u>Estate Tax</u>. If the grantor is living at the end of the trust term, any property remaining in the GRAT (which will be the case if the total return on the trust assets is greater than the IRC § 7520 rate in effect when the GRAT is created) will pass to the named beneficiaries and avoid gift and estate tax. If the grantor dies during the trust term, however, some portion of the trust property will be included in the grantor's gross estate for federal estate tax purposes. In such a case, there will be no estate tax savings. Nevertheless, the grantor will be no worse off than if he or she had not created the GRAT, except for the cost of creating the GRAT and any gift tax paid upon funding the GRAT.

The IRS has released proposed regulations providing guidance on the inclusion of trust property in a grantor's gross estate under IRC § 2036. 72 Fed. Reg. 31487-01; 2007-28 I.R.B. 74 (June 6, 2007). Generally, IRC § 2036 brings back into a decedent's gross estate the entire value of property gifted by the decedent if the decedent retained for life or for a period that does not in fact end before the decedent's death: (1) the possession or enjoyment of the property; (2) the right to the income from the property; or (3) the right, either alone or in conjunction with another person, to determine who would possess or enjoy the property or the property's income.

Under the proposed regulations, the portion of the principal includible in the decedent's gross estate is that portion of the principal, "valued as of the decedent's death (or the alternate valuation date, if applicable) necessary to yield that annual payment (or use) using the appropriate IRC § 7520 interest rate." Prop. Reg. § 20.2036-1(c)(2). The applicable IRC § 7520 rate is the rate in effect on the decedent's date of death (or the alternate valuation date, if applicable). The proposed regulations operate under the premise that, if the annuity distributes enough trust income so as to carry out all of the trust income, then IRC § 2036 will include all the trust property in the grantor's gross estate. Conversely, if the annuity is unable to carry out all of the trust income, *i.e.*, the annuity rate is less than the IRC § 7520 rate, only a portion of the trust property will be includible under IRC § 2036.

> **EXAMPLE:** D transferred $100,000 to a GRAT in which D's annuity is a qualified interest described in IRC § 2702(b). The trust agreement provides for an annuity of $12,000 per year to be paid to D for a term of 10 years or until D's earlier death. The annuity amount is payable at the end of each month in twelve equal installments. At the expiration of the term of years or on D's earlier death, the remainder is to be distributed to C, D's child. D dies before the expiration of the 10-year term. On the date of D's death, the value of the trust assets was $300,000 and the IRC § 7520 interest rate was 6%.
>
> The amount of principal with respect to which D retained the right to the income, and thus the amount includible in D's gross estate under IRC § 2036, is that amount of principal necessary to yield the annual annuity payment to D. In this case, the formula for determining the amount of principal necessary to yield the annual annuity payment to D is: annual annuity (adjusted for monthly payments) / IRC § 7520 interest rate = amount includible under IRC § 2036. The Table K adjustment factor for monthly annuity payments in this case is 1.0272. Thus, the amount of principal necessary to yield the annual annuity is ($12,000 x 1.0272) / .06 = $205,440. Therefore, $205,440 is includible in D's gross estate under IRC § 2036(a)(1).

The preamble to these proposed regulations explains that, in many cases, both IRC § 2036 and IRC § 2039 may be applicable to the annuity interest, along with other payments retained by a deceased grantor, that are the subject of these proposed regulations. IRC § 2039 includes in the gross estate any payment made by an annuity and receivable by any beneficiary under any form of contract or agreement under which a payment was to be made to the decedent during his or her lifetime. The IRS states, however, that in most cases, IRC § 2036 (and, consequently, IRC § 2035 when applicable) will apply in the future to these interests. Prop. Reg. § 20.2039-1(a); -1(e)(1).

Income Tax. The GRAT will be a grantor trust for income tax purposes. As a result of the grantor trust status, the following favorable income tax results are achieved:

- No gain or loss is recognized on the creation of the GRAT when the grantor transfers assets to fund the trust because the grantor is deemed to have transferred the assets to himself or herself for income tax purposes;
- The payment of the annual annuity by the GRAT to the grantor is ignored for income tax purposes, as the grantor is deemed to have paid it to himself or herself; and
- The income and capital gains generated by the GRAT assets are taxable to the grantor whether or not distributed to him or her.