

CHAPTER 27

Planning with GRATs

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§ 27.01 INTRODUCTION

Some of the most successful techniques devised by estate planners capitalize on generally accepted assumptions used to value gifts of partial interests in property. These assumptions do not always accurately reflect the actual or expected future performance of a particular property interest. Since the transfer tax has no post-transfer adjustment mechanism to redress unfulfilled valuation predictions, the portion of an asset's value that was not recognized at the time of transfer generally escapes transfer tax.

Transferors create partial interests in property by dividing complete interests concurrently or temporally. Concurrent fractionaliza-

tion carves a property into partial or undivided interests such as tenancies in common. The owner of Greenacre, for example, can divide it in half by giving her child a one-half undivided interest as a tenant-in-common. The value for transfer tax purposes of an undivided interest in a particular property is generally less than its pro rata portion of the value of the property as a whole.¹ Another example of concurrent fractionalization is the division of controlling corporate or partnership interests into minority interests. The values of such interests are commonly discounted well below their proportionate share of the entity's assets.²

¹ *E.g.*, *Propstra v. Commissioner*, 680 F.2d 1248 (9th Cir. 1982) (15% discount allowed); *Estate of Forbes v. Commissioner*, 81 T.C.M. 1399 (2001) (30% discount allowed); *Estate of Busch v. Commissioner*, 79 T.C.M. 1276 (2000) (10% discount allowed); *Estate of Brocato v. Commissioner*, 78 T.C.M. 1243 (1999) (20% discount allowed); *Williams v. Commissioner*, 75 T.C.M. 1758 (1998) (44% discount allowed); *Estate of Barge v. Commissioner*, 73 T.C.M. 2615 (1997) (25.95% discount allowed); *Estate of Cervin v. Commissioner*, 68 T.C.M. 1115 (1994) *rev'd* on other grounds, 111 F.3d 1252 (5th Cir. 1997) (20% discount allowed); *Lefrak v. Commissioner*, 66 T.C.M. 1297 (1993) (30% discount allowed); *Estate of Feuchter v. Commissioner*, 63 T.C.M. 2104 (1992) (15% discount allowed); *Mooneyham v. Commissioner*, 61 T.C.M. 2445 (1991) (15% discount allowed); *Estate of Youle v. Commissioner*, 56 T.C.M. 1594 (1989) (12.5% discount allowed); *Knight v. Commissioner*, 115 T.C. 506 (2000) (15% discount allowed). In PLR 9336002 (May 28, 1993) the Internal Revenue Service (the "Service") took the position that the amount of the discount should be limited to the costs of partitioning the property.

² *E.g.*, *Gross v. Commissioner*, 272 F.3d 333 (6th Cir. 2001) (25% discount allowed); *Estate of Hoover v. Commissioner*, 69 F.3d 1044 (10th Cir. 1995) (30% discount allowed); *Estate of Ford v. Commissioner*, 53 F.3d 924 (8th Cir. 1995) (20% discount allowed); *Okerlund v. United States*, 53 Fed. Cl. 341 (2002) (40% discount allowed); *Peracchio v. Commissioner*, 2003 T.C.M. LEXIS 279 (Sept. 25, 2003) (6% minority and 25% lack of marketability discounts allowed); *Lappo v. Commissioner*, 86 T.C.M. 333 (2003) (15% minority and 24% lack of marketability discounts allowed); *Hess v. Commissioner*, 86 T.C.M. 303 (2003) (15% minority and 25% marketability discounts allowed); *Estate of Deputy v. Commissioner*, 85 T.C.M. 1497 (2003) (30% discount allowed); *Estate of Dailey v. Commissioner*, 84 T.C.M. 633 (2002) (40% discount allowed); *Estate of Bailey v. Commissioner*, 83 T.C.M. 1862 (50% discount allowed); *Estate of Mitchell v. Commissioner*, 83 T.C.M. 1524 (2002) (35% discount allowed); *Estate of Adams v. Commissioner*, 83 T.C.M. 1421 (2002) (35% discount allowed); *Estate of Heck v. Commissioner*, 83 T.C.M. 1181 (2002) (35% discount allowed, a portion of which was attributable to the existence of a right of first refusal); *Estate of Baird v. Commissioner*, 82 T.C.M. 666 (2001) (60% discount allowed); *Estate of Frank v. Commissioner*, 69 T.C.M. 2255 (1995) (20% discount allowed); *Estate of Stevens*

In contrast, temporal fractionalization divides property on a time basis. For example, the owner of Greenacre can divide the property by giving her child the right to possess it for a period of time or the right to receive outright ownership of it after the expiration of a period of time. The period may be measured by reference to the life of an individual, typically the owner or the child, or some specified term of years.

A temporal division is usually, but not necessarily, accomplished through the mechanism of a trust. The transferor transfers property to a trustee subject to the terms of a trust instrument that defines how the beneficiaries are to share or benefit from the property. The trust instrument, for example, could direct that one beneficiary receive the income from the transferred property (or enjoy the possession of it) for a specified period of time, and that after the expiration of that period, another individual receive the property outright.

v. Commissioner, 79 T.C.M. 1519 (2000) (25% discount allowed); *McCord v. Commissioner*, 2003 T.C. LEXIS 16 (May 14, 2003) (15% minority and 20% marketability discounts allowed); *Estate of Knight v. Commissioner*, 115 T.C. 506 (2000) (15% discount allowed); *Shepherd v. Commissioner*, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002) (15% discount allowed). The Service had taken the position that such discounts should not be available when family members as a group control the entity. Rev. Rul. 81-253, 1981-2 C.B. 187. It seldom succeeded in court. See, e.g., *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982); *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981); *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982); *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978), *nonacq.*, 1980-2 C.B. 2. In Rev. Rul. 93-12, 1993-1 C.B. 202, the Service capitulated. It revoked Rev. Rul. 81-253 and announced its acquiescence as to this issue in the *Estate of Lee* case. In TAM 9432001 (March 28, 1994) the Service permitted a minority discount to be used in valuing a 48.59% minority interest in a corporation bequeathed to a shareholder who held the other 51.41%. But see *Estate of Murphy v. Commissioner*, 60 T.C.M. 645 (1990). In *Estate of Murphy*, the decedent's holdings were converted into a minority interest by transfers decedent made to her children 18 days before death. The court found the "facts in this case are extreme," and, distinguishing this case from *Estate of Bright*, held that "(a) minority discount should not be applied if the explicit purpose and effect of fragmenting the control block of stock was solely to reduce Federal tax." The court denied that it had applied family attribution to reach its result. See also TAM 9436005 (May 26, 1994) in which the Service took the position that the valuation of 3 simultaneous gifts of 30% interests in a corporation should reflect the value of the swing vote attribute of each gift, and TAM 9449001 (March 11, 1994) in which the Service permitted a discount for gifts of 100% of the stock in a corporation in equal shares to eleven siblings.

When a transferor gives a temporal interest in property and retains another interest, the value of her gift is determined according to actuarial tables prescribed by the Treasury pursuant to Code Sec. 7520.³ The tables use an interest rate equal to 120% of the federal

³ Treas. Reg. § 25.2512-5(d). References to "Code Sec." are to sections of the Internal Revenue Code of 1986, as amended (the "Code"). References to "Treas. Reg. § " are to the regulations promulgated under the Code by Treasury. Prior to May, 1989, the value of gifts of annuities, income interests, and remainders was determined in accordance with tables set forth in Treas. Reg. § 25.2512-5(A). For gifts made on or after May 1, 1989, Code Sec. 7520 requires that valuation be determined under tables prescribed by Treasury that use an interest rate (rounded to the nearest 2/10ths of 1 percent) equal to 120% of the federal mid-term rate in effect under Code Sec. 1274(d)(1) for the month in which the gift is made. The federal mid-term rate is a rate based on the average market yield on marketable obligations of the United States with remaining terms of 3 to 9 years. Code Sec. 1274(d)(1); Treas. Reg. § 1.1274-4(b).

The courts have sometimes authorized departure from the tables in the regulations when their use to value a temporal interest in a particular property would produce a "substantially unrealistic and unreasonable result." See, e.g., *O'Reilly v. Commissioner*, 973 F.2d 1403 (8th Cir. 1992). In *O'Reilly*, the Eighth Circuit concluded that the regulations' direction to use the tables was superseded by the more fundamental valuation principle contained in the regulations—"The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." Treas. Reg. § 25.2512-1.

This rationale should not permit a departure from the tables for gifts made after April 30, 1989 since Code Sec. 7520 seems to mandate the use of the tables in all events. Nevertheless, Treasury has recently finalized amendments to the regulations under Code Sec. 7520 that permit departure from the standard Code Sec. 7520 factors in the case of certain "restricted beneficial interests." Specifically, Treas. Reg. § 25.7520-3(b) disallows use of the Code Sec. 7520 factors when valuing 1) an annuity which, if paid for a specified term of years or for the life of one or more individuals, is expected to exhaust the fund before the last possible payment is made, 2) an income interest if its governing instrument allows income or corpus to be paid during the term to anyone other than the income beneficiary without the beneficiary's consent, or if the governing instrument does not provide the income beneficiary with that degree of beneficial enjoyment of the property that the principles of the law of trusts accord to a person who is unqualifiedly designated as the income beneficiary of a trust, and 3) a remainder or reversion interest in which the beneficiary is not assured by the terms of the instrument and the surrounding circumstances that the property will be adequately preserved. In addition, the regulations disallow use of the factors in valuing any of the above interests when an individual who is a measuring life is known to have an incurable illness and is determined to have at least a 50% chance of dying within 1 year

mid-term rate in effect under Code Sec. 1274 on the date of the gift. The interest rate is changed monthly. This method achieves a sensible result in the case of a gift of the right to receive income from property for a period of time (an "income interest") or the right to receive the property after a period of time (a "remainder interest") if the property produces an income stream consistent with the applicable interest rate and if its value does not increase or decrease.

There are at least two significant problems with this approach from the standpoint of economic reality. First, the valuation is based on a prediction that the property will produce an income stream consistent with the applicable interest rate and that its value will not increase or decrease. If the property produces income at a rate lower than the applicable interest rate, the income interest will have been overvalued. If the property appreciates in value, the remainder interest will have been undervalued.

Second, the approach ignores the fact that the Code Sec. 7520 rate is derived from taxable interest rates paid on a principal sum that will not itself be subject to income tax. When a donor divides property between a retained income interest and a remainder interest, she converts her interest into a fully taxable interest, and converts the interest given to her donee into a tax-free interest. By paying current income tax on all of the income she receives, she enables the interest given to her donee to grow tax free up to her original basis in the property.⁴

of the gift. If, however, the individual in fact survives for 18 months after the gift, the individual is presumed not to have been terminally ill at the date of the transfer.

In addition, recent decisions in the estate tax context have also permitted departure from the valuation tables. See, e.g., *Estate of Gribauskas v. Commissioner*, 2003 U.S. App. LEXIS 17770 (2d Cir. Aug. 26, 2003) (holding that marketability restrictions, in this case a Connecticut law that prohibited the assignment of rights to lottery winnings, may render valuation under the Code Sec. 7520 tables "unreasonable and unrealistic," thereby justifying departure from the tables); *Estate of Shackelford v. United States*, 262 F.3d 1028 (9th Cir. 2001) (upholding the district court's finding that application of the valuation tables did not accurately reflect economic reality). But see *Estate of Cook v. Commissioner*, 82 T.C.M. 154 (2001) (denying departure from valuation tables under facts substantially similar to those in *Estate of Gribauskas* and *Estate of Shackelford*).

⁴ For a more detailed discussion of this issue, see Gans, "GRIT's, GRAT's and GRUT's: Planning and Policy," 11 Va. Tax Rev. 761 (1992).

Suppose in a month when the Code Sec. 7520 rate is 4%, an individual transfers \$100,000 to a trust to pay her the income for 10 years, remainder to her child. The value of her retained interest is \$32,444 and the value of her gift to her child is \$67,556. If the valuation predictions were fulfilled, at the end of the 10 years, the transferor would have \$48,024 and the child would have the original \$100,000. The key test here is that the proportions between what they have remain the same. The child has 67.5% and the transferor has 32.4%.

This is unlikely to happen. Even if the property produces an annual 4% return and the principal does not increase in value, the predictions will turn out to be wrong because of the income tax impact on what the transferor has retained. Suppose the transferor's income tax rate is 35%. At the end of the 10 years, she will have only \$29,300—about 23% of what she and her child both have, instead of the target 32.4%

If the property doesn't produce the 4% current return and if its value actually appreciates, the disparity between the gift tax valuation and reality becomes greater. Suppose the property produces an overall annual return of 4%, but only 2% is current income and the rest is appreciation. At the end of the 10 years the transferor will have only \$15,000.⁵ Her child will have \$122,000, \$22,000 of which will be subject to income tax, leaving her with about \$118,600, after tax.⁶ In this case, the transferor will have only 11% of the combined amount instead of 32.4%. This was very successful estate planning. The transferor paid a gift tax on 67.5% of an asset and actually removed 89% of it from her gross estate.

The Service has no way of compensating for this because the transfer tax system does not contain any post-transfer mechanisms for adjusting values after a gift has actually been made, no matter how erroneous the valuation turns out to be with hindsight.

From the standpoint of the Service, the problem is compounded by the fact that investment decisions will play an important role in determining whether the return obtained from an investment is received in the form of current income or in the form of capital appreciation held for ultimate distribution to the remainder beneficiary. As a result, the trustee has the power to affect the extent to

⁵ This assumes reinvestment of income distributions at 4%.

⁶ This assumes a capital gains tax rate of 15%.

which the assumptions used to value the temporal interests are fulfilled.

Much has been written about the transfer tax benefits of splitting property interests temporally. Those interested in helping individuals transfer wealth intact to their children and more remote descendants have extolled the advantages;⁷ others whose concern lies with the integrity of the transfer tax system have condemned the technique as a loophole exploited by the wealthy.⁸

Congress listened to the latter group and in 1990 took a step reflective of its 1969 reform of split-interest charitable gifts.⁹ It significantly reduced the valuation advantage of gifts of temporal interests, first by directing that the value of the gift be determined by subtracting the value of the transferor's retained interest from the value of the entire property, and then by imposing a general rule that assigns a zero value to most types of retained temporal interests.¹⁰ The consequences of the application of the new rule are draconian. Under Code Sec. 2702, unless the retained interest is a "qualified interest" or unless one of the section's exceptions applies, the value of a gift by a parent of a remainder interest in property to her child will be equal to the property's total value regardless of how long the child must wait to receive it.¹¹

⁷ See generally Abbin, "The Politics of Transfer Taxation or Watching Sausage Being Made—Is Anyone in Charge?" *The Twenty-Fifth Annual Philip E. Heckerling Institute on Estate Planning*, ¶ 400 (1991); Adams, "Value Shifting Techniques—Bang or Bust?" *The Twentieth Annual Philip E. Heckerling Institute on Estate Planning*, ¶ 1300 (1986).

⁸ E.g., Boyle, "Evaluating Split-Interest Valuation," 24 *Ga. L. Rev.* 1 (1989); Dodge, "Redoing the Estate and Gift Taxes Along Easy-To-Value Lines," 43 *Tax L. Rev.* 241 (1988); Gutman, "A Comment on the ABA Tax Section Task Force on Transfer Tax Restructuring," 41 *Tax Law.* 653 (Spring 1988). See also Gutman, "Reforming Federal Wealth Transfer Taxes After ERTA," 69 *Va. L. Rev.* 1183, 1217 (1983).

⁹ Tax Reform Act of 1969, Pub. L. No. 91-172, § 201.

¹⁰ Code Sec. 2702. This section was added to the Code as part of the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602(a), 104 Stat. 1388 (1990). It is an integral part of Chapter 14 of the Code, which is intended to provide a series of rules for discouraging a variety of transfer tax valuation techniques, including recapitalizations of entities, temporal divisions of property, and value-reducing agreements such as options and buy-sell agreements.

¹¹ Code Sec. 2702 applies to any transfer of an interest in trust to a family member of the transferor if the transferor or an applicable family member retains an

Code Sec. 2702 contains a number of exceptions to its zero valuation rule. Some of these exceptions continue to furnish estate planning opportunities reminiscent of those available prior to Code Sec. 2702's enactment. This outline focuses on one of them—the Grantor Retained Annuity Trust, the “GRAT”¹² It explains what a GRAT is and discusses the transfer and income tax consequences of its creation and administration.

As discussed above, the economic reality is that if property placed in a split-temporal-interest trust produces income at a rate lower than the applicable interest rate, the income interest will have been overvalued, and if the property appreciates in value, the remainder interest will have been undervalued. Since the income interest is always going to be over or under-valued, it makes sense under our gift tax system to arrange matters, if possible, so that the benefits of overvaluation inure to the donees while minimizing the cost to the donor in the event of an undervaluation. This can, it turns out, be relatively easy to accomplish, due to the fact that there is a very low fixed floor on the risk of overvaluing the retained income interest: that floor is between zero and a thousand dollars, say. But there is no ceiling on the possibility of undervaluing the retained interest, since if the property appreciates, it can appreciate to anything, and all of that appreciation can inure to the benefit of the donee without being subject to gift tax. This is the key to the reason that GRATs, post *Walton*, work so well.

Until recently, it was not possible to be sure that a “zeroed-out” GRAT would work. The “reason,” according to the IRS' former

interest in the trust. The term “family member” means the transferor's spouse, any ancestor or descendant of the transferor or her spouse, any sibling of the transferor, and the spouse of any such ancestor, descendant, or sibling. Code Secs. 2702(e) and 2704(c)(2). The term “applicable family member” means the transferor's spouse, any ancestor of the transferor or her spouse, and the spouse of any such ancestor. Code Secs. 2702(a)(1) and 2701(e)(2). Transfers of property in trust include transfers of temporal interests in property not actually held in a formal trust. Code Sec. 2702(c). The acquisition of a term interest in property by an individual, if a member of her family as part of the same transaction or series of related transactions acquires other interests, is also treated as a transfer in trust. Code Sec. 2702(c)(2).

¹² Other exceptions not discussed in this paper include the grantor retained unitrust (Code Sec. 2702(b)(2)), the noncontingent remainder interest (Code Sec. 2702(b)(3)), the Qualified Personal Residence Trust (Code Sec. 2702(a)(3)), and the tangible property trust (Code Sec. 2702(c)(4)).

position, that a GRAT would always result in at least some significant gift tax, particularly where the donor was an older person, was that the grantor might die prior to the end of the GRAT's term, in which case the remaining payments under the GRAT would not pass to the grantor. The actuarial odds of this happening were factored into the value of the gift by subtracting the value of this contingent annuity or unitrust interest from the value of the retained interest, increasing the value of the gift commensurately (even though the "gift" remained in the grantor's estate). Virtually all commentators thought this interpretation to be unsupported by the statute: strained at best, and entirely lacking in formal logic at worst. Fortunately, the Tax Court, in *Walton*,¹³ had the good sense to agree with the commentators and disagree with the IRS, despite the fact that the IRS position is contained in the interpretive regulations (the infamous Ex. 5).¹⁴ *Walton*¹⁵ declared the regulations invalid on this point. The IRS recently acquiesced in the *Walton* case and announced that it was withdrawing Treas. Reg. § 25.2702-3(e), Ex. (5).¹⁶

Despite the draconian impact of Sec. 2702 on transfers where the retained interest is not a "qualified interest," the economic realities discussed above can be used in a GRAT to shift all of the benefits of over-performance to the donees, with little or no transfer cost to the donor. This is easily done under a GRAT by making the "qualified retained interest" almost large enough to equal the theoretical value of the entire interest, because in that case the gift tax value of the GRAT is close to zero. In that situation, if the property transferred to the GRAT out performs the Sec. 7520 interest rate assumptions, the benefits of the excess growth inures to the donees (remainder beneficiaries); but if the GRAT does not grow at the Sec. 7520 rate, the detriment to the donor/grantor is minimal, because the gift was close to zero in any case. It follows that the upside potential is unlimited, and the downside risk is nominal. This is a very desirable set of contingencies, obviously.

¹³ *Audrey J. Walton v. Commissioner*, 115 T.C. 589 (2000), acq. Notice 2003-72, 2003-44 IRB, 10/15/2003.

¹⁴ Treas. Reg. § 25.2702-3(e), Ex. (5).

¹⁵ *Walton*, *supra*.

¹⁶ Notice 2003-72, 2003-44 IRB, 10/15/2003.

§ 27.02 DEFINING THE GRAT

[1] In General

A GRAT, as the term “grantor retained annuity trust” suggests, is a trust that pays an annuity to its grantor for a specified period of time. At the end of the period, the beneficial interest in the trust shifts to another beneficiary or beneficiaries.

Example 1: Jennifer transfers \$1,000,000 to a trust. The terms of the trust instrument require the trustee to pay her \$80,000 per year for 10 years. At the end of the 10 years, any property remaining in the trust is to be paid to her son Patrick.

If the terms of the trust satisfy the requirements described below, the grantor’s interest is a “qualified annuity interest” and Code Sec. 2702’s zero valuation rule does not apply to it.¹⁷ Instead, the value of the grantor’s retained annuity interest is determined under Code Sec. 7520.¹⁸

Congress has sanctioned the GRAT because its structure seems to preclude the manipulation of investment decisions for the purpose of shifting economic enjoyment between the income and remainder beneficiaries. The annuitant is entitled to receive the annuity no matter what the trust’s income is. Thus, a trustee whose object is to maximize the interest of the trust’s remainder beneficiaries would have no incentive to maximize growth opportunities at the expense of current income.¹⁹ So long as the total return, be it income or appreciation, is consistent with the Code Sec. 7520 rate, a GRAT’s

¹⁷ Code Sec. 2702(a)(2) and (b)(1); Treas. Reg. § 25.2702-2(a)(5) and (6); Treas. Reg. § 25.2702-2(b)(2).

¹⁸ Code Sec. 2702(a)(2)(B).

¹⁹ The trustee might, however, have an incentive to maximize the possibility of a higher overall return by making speculative investments. If the GRAT is structured initially with a zero or relatively small remainder interest, the risk burden will be borne entirely or almost entirely by the annuitant while the remainder beneficiary will enjoy the rewards but not the risks of a successful speculative investment. In contrast, the grantor retained unitrust, a sibling to the GRAT, eliminates this incentive. A unitrust interest is an annuity the amount of which is determined by the annual value of the property. Since the amount of the payments to the annuitant fluctuates with the value of the trust property and the income that it earns, the benefits and burdens of all investments are shared proportionately by the annuitant and the remainder beneficiary.

annuitant and its remainder beneficiaries will each receive their appropriate share of trust assets.

The advantage, from the government's point of view, of the GRAT over the trust that pays income to an income beneficiary for a specified period of time, is illustrated by the following examples.

Example 2: Suppose that the trust described in Example 1 required that Jennifer receive all trust income for 10 years (a grantor retained income trust or GRIT) rather than an \$80,000 annuity. If the Code Sec. 7520 rate is 8%, the value of Jennifer's retained interest (in the absence of Code Sec. 2702's zero valuation rule) will be the same. The right to receive an \$80,000 annuity for 10 years is worth \$536,806 as is the right to receive all of the income from a \$1,000,000 investment for 10 years. The right to receive the remainder at the end of 10 years is worth \$463,193. The fund is invested to produce annual income of 8% and no growth. If Jennifer invests her income distributions to achieve an 8% return, at the end of the 10-year period, Jennifer will have \$1,158,925, and Patrick will have \$1,000,000.

Example 2's result is appropriate because it is consistent with the relative values assigned to the income interest and the remainder interest at the time of Jennifer's transfer to the trust. Jennifer's interest was worth \$536,806. Example 2 shows that if Jennifer had invested her \$1 million for 10 years in assets that produced no capital growth, but did produce interest income at 8%, she would have had \$1,158,925 at the end of the 10 years and Patrick would have \$1 million. When discounted to present value, Patrick's interest would only be worth \$483,193, and Jennifer's interest would be worth \$536,806. The value of Patrick's remainder interest and Jennifer's retained interest are the same under the gift tax laws, regardless of the actual investment return, and regardless of what the fiduciary income component on the investment return actually is.

As illustrated by Example 3, a change in the form of the investment, after the gift tax has been fixed and computed, can shift property to Patrick and away from Jennifer, even where the overall rate of income and growth is the same as in Example 2 (i.e., 8%).

Example 3: The trustee of the trust described in Example 2 invests the trust's \$1,000,000 to achieve an annual income of 4%

and appreciation of 4%. Using the same assumptions as to Jennifer's reinvestment, at the end of the 10 years, she will have only \$678,680. What Jennifer has lost from this investment approach, Patrick will gain. The trust principal distributed to him at the end of the 10 years will be \$1,480,244.

But for Sec. 2702, the result of Example 3 is a transfer to Patrick free of gift tax (and free of any other transfer tax) of \$480,244. The GRAT structure prevents the result of Example 3. A GRAT would have made \$80,000 annual payments to Jennifer even though the trust's income was only \$40,000. As a result, she would have \$1,158,925 at the end of the 10-year term and Patrick would have only \$1,000,000.

Prior to the enactment of Code Sec. 2702 a grantor could retain an income interest in a trust (a GRIT), in which the remainder passed to a "member of the family"²⁰ of the grantor, and compute the value of the gift of the remainder for gift tax purposes at its actuarial value.²¹ The unstated assumption behind the gift tax valuation method then applicable was that the trust was likely to produce fiduciary accounting income commensurate with the statutory rate. However, as illustrated by Example 3, this assumption could be easily proved wrong if the trustee, who often was the grantor, invested for growth instead of income. In that case, as the example illustrates, the value of the retained income interest would be overstated; and, not coincidentally, the value of the gift of the remainder would be undervalued. Code Sec. 2702 proscribed this valuation method in those cases where a beneficiary is a "member of the family" of the grantor.

Under Code Sec. 2702, a GRIT for a member of the family will be valued for gift tax purposes as if the entire interest transferred to the trust were given to the remainder beneficiaries immediately.

²⁰ IRC § 2704(c)(2) provides:

(2) **Member of the family.** The term "member of the family" means, with respect to any individual—

- (A) such individual's spouse,
- (B) any ancestor or lineal descendant of such individual or such individual's spouse,
- (C) any brother or sister of the individual, and
- (D) any spouse of any individual described in subparagraph (B) or (C).

²¹ This technique (the "GRIT" technique) is may still be viable when the beneficiary is a nonspouse significant other, a niece, nephew, etc.

This result occurs because the interest retained by the transferor is not a "qualified retained interest", and, thus, is treated as having a value of zero. A qualified interest includes fixed amounts payable to the grantor, such as a GRAT provides, but definitely does not include an indeterminate "income" interest, because Congress realized that an indeterminate income interest is too easily subject to manipulation by grantors who, after the gift, may seek or acquiesce in an investment policy favoring the remainder beneficiaries.

Example 3 above illustrates the effect that an investment strategy favoring growth over fiduciary accounting income can have on what the income and remainder beneficiaries actually receive.

[2] The Regulations' Governing Instrument Requirements

Code Sec. 2702(b)'s definition of a qualified annuity interest is a simple one. It requires only that the interest "consist[] of the right to receive fixed amounts payable not less frequently than annually."²² The regulations, however, have superimposed an intricate web of requirements that are similar, but not identical, to the governing instrument requirements of charitable remainder annuity trusts and charitable lead annuity trusts.²³ These requirements are discussed below.

The regulations' requirements must be satisfied by appropriate provisions in the trust's governing instrument.²⁴ Apparently, if they

²² Code Sec. 2702(b)(1).

²³ Treas. Reg. § 25.2702-3(b) and (d). The Senate Explanation (the Finance Committee explanation submitted by Senator Bentsen in connection with the Senate version of OBRA '91, set forth in 136 Cong. Rec. S15629.03 (daily ed. Oct. 18, 1990)) stated that the requirements for the qualified interests described in Code Sec. 2702(b) were intended to be similar to the requirements for "charitable split interest trusts under section 664." The explanation preceding the proposed Code Sec. 2702 regulations (56 Fed. Reg. 14321 (Apr. 9, 1991)) states that the definitions in the proposed regulations "generally look to the rules governing charitable lead annuity and unitrust interests." 56 Fed. Reg. at 14324. The charitable lead trust regulations provide a more appropriate model than do the charitable remainder trust regulations since Treasury's objective for charitable lead trusts is the same as that for qualified annuity interests: to assure that the amounts the annuitants actually have the right to receive are consistent with the original valuation assumptions.

²⁴ The regulations define the term "governing instrument" as "the instrument

are satisfied as of the date of the grantor's transfer to the trust, the interest will be valued as a qualified interest.

The regulations do not impose any adverse consequences if the parties, the trustee, and the beneficiaries, subsequently decide to disregard a requirement contained in the trust instrument. For example, as discussed below, the regulations require that the trust instrument prohibit prepayment of the annuity. In many states, the creator of a trust, with the consent of all of the beneficiaries, may revoke or amend the terms of a trust.²⁵ What would the consequences be under Code Sec. 2702 if a trust that otherwise qualified as a GRAT were subsequently amended to provide a commutation clause?²⁶

[a] *The Annuity Amount*

[i] *Time for Payment*

The regulations originally provided that the trust instrument must require that the annuity amount be payable for each taxable year of the trust. Most GRATs will be on a calendar year basis. The requirement that the annuity be payable for each calendar year meant that for GRATs that were started on a date other than January 1, the first annuity payment was required to be paid within, rather than at the end of, the first full year of its existence.²⁷

A 2000 amendment to this regulation created more flexibility. The new regulation makes it clear that the annuity may be payable

or instruments creating and governing the operation of the trust arrangement." Treas. Reg. § 25.2702-2(a)(9). This outline refers to the governing instrument as the "trust instrument."

²⁵ See, e.g., Cal. Prob. Code § 15404; Fla. Stat. § 737.4032; and NY EPTL § 7-1.9.

²⁶ The Service might take the position that an amendment is a new transfer and, if the trust immediately after the amendment does not satisfy the regulations' requirements, subject the full value of the trust to gift tax. An amendment, however, that resulted in the simultaneous termination of the trust would probably not be vulnerable to a new application of Code Sec. 2702 since, immediately after the amendment, neither the transferor nor any other family member would have an interest in the trust.

²⁷ Treas. Reg. § 25.2702-3(b)(1)(i).

annually (or more frequently) based on the anniversary date of the trust as well as the taxable year of the trust.²⁸

The trust instrument must require proration of the annuity payment made for a period of less than 12 months in the same manner as is required for charitable remainder annuity trusts under Treas. Reg. § 1.664-2(a)(1)(iv). A clause similar to the following would satisfy this requirement for a GRAT that requires payment of the annual amount in each taxable year of the trust:

In determining the annuity amount, the Trustee shall prorate such amount on a daily basis for any short taxable year and for the taxable year in which the Trust terminates.²⁹

The annuity must be paid to the annuitant whether or not the trust has produced income equal to the annuity. If income is insufficient, the trustee must be required to invade principal to pay the annuity. Since the regulations' requirements are all governing instrument requirements, they do not stipulate a penalty for a trustee's failure to make timely payment of the annuity amount. A grantor's failure to enforce her right to receive a prompt payment might be treated as an additional gift to the trust of an amount equal to the value of an interest-free loan of the amount of the annuity for the period of time it remains unpaid.³⁰

The regulations require that the annuity must be paid no later than 105 days after the anniversary date of the creation of the trust if the annuity is payable based on the anniversary date and no later than the date on which the trustee must file the trust's income tax return (determined without extensions) if the annuity amount is payable based on the taxable year of the trust.³¹

²⁸ Treas. Reg. § 25.2702-3(b)(3). T.D. 8899, 65 Fed. Reg. 53587 (September 5, 2000).

²⁹ This clause appeared in the trust instrument described in PLR 9239015 (June 25, 1992). The Service determined that the annuity payment required by that trust instrument was a qualified annuity interest.

³⁰ See *Dickman v. U.S.*, 465 U.S. 330 (1984). The Service has taken the position in a number of private rulings that a trust income beneficiary's failure to require the trustee of a trust to invest in assets producing a reasonable rate of return constituted a gift by her to the remainder beneficiaries. *E.g.*, PLR 9112007 (December 20, 1990), PLR 9049033 (September 10, 1990), PLR 9046026 (August 16, 1990).

³¹ Treas. Reg. § 25.2702-3(b)(4). It is not clear whether express permission in

[ii] *Requirement of Actual Payment*

The trust instrument must require that the trustee actually pay the annuity amount to or for the benefit of the annuitant, referred to in the regulations as the “holder of the annuity interest.” It is not sufficient to give her the annual right (even a cumulative right) to withdraw the annuity amount.³²

Nor is it sufficient for the trustee to issue notes to satisfy the annuity payment, since the effect of the issuance of notes is to defer the annuitant’s receipt of payment. The regulations state that the “issuance of a note, other debt instrument, option or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount.”³³ The explanatory material that preceded the final regulation in the Federal Register makes it clear that borrowing from a third party to raise funds to pay the annuity amount will be permitted but that the step transaction doctrine will be applied if a series of transactions is used to achieve the same economic result as a borrowing from the grantor. For example, a borrowing by the GRAT from a bank to pay the annuity followed by a borrowing from the grantor to repay the bank would not be permitted. The use of the phrase “directly or indirectly” in the final regulations is intended to convey this idea.³⁴

the trust instrument to delay a payment nominally due on a particular date to a later date will be reflected in a lower valuation for the annuity. Arguably, such an annuity does have a lower value because of the trustee’s power to deny the use of the annuity amount to the grantor for 105 days.

³² *Id.* This requirement is inconsistent with the Code, which requires only that the annuitant have the “right to receive” the annuity. It does not seem to further any legitimate objective of Treasury. Treasury’s purpose here should be limited to assuring that the amounts the annuitant actually has the right to receive are consistent with the original valuation assumptions. Whether the annuitant actually receives the payments should not concern Treasury. If the annuitant has the right to receive a noncumulative payment, the lapse of the right to receive it would be a transfer for gift tax purposes. If the annuitant’s right is cumulative, her failure to exercise the right should be treated as a loan to the trust subject to the provisions of Code Sec. 7872 (dealing with loans with below-market interest rates). If no interest is charged, the failure to withdraw would result in a taxable gift to the extent of the foregone interest calculated at the applicable rate.

³³ Treas. Reg. § 25.2702-3(b)(1)(i).

³⁴ 65 Fed. Reg. 53587 (September 5, 2000).

The regulations also provide that the GRAT instrument “must prohibit the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity . . . payment obligation.”³⁵

[iii] *Defining the Annuity*

The annuity amount must be a fixed amount. By this the regulations mean an amount that is fixed in the trust instrument either in terms of a fixed dollar amount or in terms of a fixed percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes.³⁶ The Service will not ordinarily issue rulings on whether annuity interests are qualified annuity interests under Code Sec. 2702 if the amount of the annuity payable annually is greater than 50% of the initial net fair market value of the property transferred to the trust, or if the value of the remainder interest is less than 10% of the initial net fair market value transferred to the trust.³⁷ If the ruling position of Rev. Proc. 2003-3 were actually a requirement for qualification for a GRAT, a zeroed-out 2-year GRAT would be impossible on two counts. (1) In order to zero out the GRAT, a payout of over 50% would be required. (2) A zeroed-out GRAT, by definition, contemplates that the value of the remainder will be less than 10% of the initial corpus.

A similar rule was adopted in legislation affecting charitable remainder trusts (CRTs). Like the zeroed-out GRAT, but in reverse, it used to be possible, prior to a change in the Code, to structure a CRT so that the value of the remainder interest passing to charity was negligible. An easy way for Congress to prevent the perceived abuse allowed by *Walton* type GRATs would be to legislate the provisions of Rev. Proc. 2003-3 into law.

Although not an issue addressed by the Tax Court in *Walton*, it is notable that the two proscriptions preventing a favorable ruling were violated in the *Walton* case. The second year’s annuity in *Walton* was expressed as 59% of the original value of the property transferred and the retained interest was .006% of the initial value of the property transferred.

³⁵ Treas. Reg. § 25.2702-3(d)(5).

³⁶ Treas. Reg. § 25.2702-3(b)(1)(ii).

³⁷ Rev. Proc. 2003-3, 2003 I.R.B. 113, § 4.01(49).

The regulations do not require that the fixed amount be the same for each year. The only requirement imposed on variations in amounts payable from year to year is the requirement that an amount payable in one year not exceed 120% of the amount payable in the prior year.³⁸ The following two examples illustrate the two ways of defining a qualified annuity interest:

Example 4: John transferred \$1,000,000 to a 4-year trust. The terms of the trust required the trustee to pay him an annuity of \$100,000 in the first year, \$90,000 in the second year, \$50,000 in the third year, and \$60,000 in the fourth year. After the fourth payment has been made to John, the trustee is required to distribute the remaining trust assets to his son Patrick.

Example 5: Jennifer transferred 100 shares of the X corporation to a 4-year trust. The terms of the trust required the trustee to pay her an annuity equal to 10% of the initial value of the trust assets in the first year, 12% in the second year, 14% in the third year, and 16% in the fourth year. In each case the value is to be the value as finally determined for federal tax purposes. After the fourth payment has been made to Jennifer, the trustee is required to distribute the remaining trust assets to her son Patrick.

If the trust property will appreciate over the term of the trust at a uniform rate and if annuity payments will have to be made from trust principal or from income that could have been invested to produce the same rate of return as principal, a pattern of increasing annuity payments will produce more value for the beneficiaries at the end of the term than would a pattern of constant annuity

³⁸ *Id.* In this respect, the GRAT regulations differ from the regulations governing charitable lead annuity trusts. The latter permit any degree of variation from year to year so long as the pattern of payments is fixed in the trust instrument. Treas. Reg. § 25.2522(c)-3(c)(2)(vi)(a). As proposed, the GRAT regulations did not permit any variation. Treasury explained that the change was “[I]n response to comments requesting that increases in the annuity and unitrust amounts be permitted throughout the term. . . . The proposed regulations prohibited increases to prevent transferors from ‘zeroing out’ a gift while still effectively transferring the appreciation on all the property during the term to the remainder beneficiary, (e.g., by providing for a balloon payment in the final year of the term). The Treasury Department and the Service believe that such a result would be inconsistent with the principles of Code Sec. 2702. The final regulations, with minimal complexity, strike a balance between the government’s policy concerns and taxpayers’ desire for planning flexibility.”

payments. This may be particularly useful, especially in the case of a GRAT is funded with discounted interests in an entity such as a non-controlling interest in a closely held corporation when it is expected that income might initially exceed the annuity payments, because the build up can serve as leverage. In any case, if the GRAT outperforms the Code Sec. 7520 rate, the extra amount left in the trust is not only outperforming the Code Sec. 7520 rate but it is earning additional dollars for the remainder beneficiaries at the higher rate while doing so.

Treas. Reg. § 25.2702-3(e), Ex. (3) clearly allows the annuity to decrease without apparent limit. It may be that the decreases must be made in two year increments, at a minimum, on the theory that what you have is a series of annuities, and that an annuity must be for more than one year. However, this is unclear, since increasing the annuity each year, within the 120% ceiling, does not pose a problem. A decreasing annuity might result in less of an estate tax inclusion if the grantor dies during the term and if the taxpayer is successful in arguing that inclusion is limited to § 2036(a)(1)³⁹ rather than § 2039, which unfortunately is a position with which the Service is unlikely to agree.⁴⁰

Table 1 below compares the two different approaches. The table assumes an initial principal of \$1,000,000, a Code Sec. 7520 rate of 8% when the trust is created, an annual growth rate of 10%, a ten-year term, and an annuity pattern the value of which (at the start of the trust) is equal to \$1,000,000. The annuity pattern set forth in column "[3]" increases by 120% per year; the one set forth in column "[5]" remains constant. The remainder beneficiaries receive 29% more when the annuity is set to increase by 120% each year than they would if the annuity remained constant throughout the term of the trust.⁴¹

³⁹ See Rev. Rul. 82-105 1982-1 C.B. 133.

⁴⁰ See, for example, PLRs 9345035 and 9451056.

⁴¹ For another discussion of this technique, see Covey, Practical Drafting 5625 (April 1999). An increasing stream of annuity payments could increase the portion of trust assets that would be includable in the gross estate of the transferor if she died before the end of the annuity term. See discussion below.

Table 1

[1] Year	[2] Principal	[3] Annuity	[4] Principal	[5] Annuity
	10% Growth		10% Growth	
1	\$1,000,000	\$50,268	\$1,000,000	\$123,291
2	\$1,049,732	\$60,322	\$976,709	\$123,291
3	\$1,094,383	\$72,386	\$951,089	\$123,291
4	\$1,131,435	\$86,864	\$922,907	\$123,291
5	\$1,157,714	\$104,237	\$891,907	\$123,291
6	\$1,169,249	\$125,084	\$857,806	\$123,291
7	\$1,161,090	\$150,101	\$820,296	\$123,291
8	\$1,127,099	\$180,121	\$779,035	\$123,291
9	\$1,059,688	\$216,145	\$733,647	\$123,291
10	\$ 949,512	\$259,374	\$683,721	\$123,291
Balance	\$ 785,089	Balance	\$628,802	

The regulations permit the trustee to distribute amounts in excess of the annuity amount to the annuitant.⁴² The distributions may be made from income or principal. The value, however, of any rights to receive payments in addition to the qualified annuity interest has a zero value for gift tax purposes.⁴³ As a theoretical matter, the Service could argue, depending on the types of distributions permitted or required, that such additional rights affect the value of the annuity interest. However, if the annuity, as a percentage of the initial fair market value, exceeds the Code Sec. 7520 rate, the retention of the right to receive any income in excess of the annuity amount should not affect the valuation of the annuity interest.⁴⁴

Finally, the regulations require that, if the annuity amount has been defined as a percentage of or as a fraction of the value of the trust's assets, the trust instrument contain a provision requiring

⁴² Treas. Reg. § 25.2702-3(b)(1)(iii).

⁴³ *Id.*

⁴⁴ A similar issue arises under Code Sec. 2503 in connection with the qualification of an income interest for the annual exclusion when the trustee of the trust with respect to which the income interest exists also has the power to make principal distributions to the income beneficiary. Treas. Reg § 25.2503-3 (b) resolves this issue in favor of the taxpayer by providing, "[i]f a donee has received a present interest in property, the possibility that such interest may be diminished by the transfer of a greater interest in the same property to the donee through the exercise of a power is disregarded in computing the value of the present interest, to the extent that no part of such interest will at any time pass to any other person. . . ."

adjustment of annuity amounts previously paid if an error was made by the trustee in determining such value. The adjustment clause must satisfy the requirements of Treas. Reg. § 1.664-2(a)(1)(iii), which deals with a similar problem in connection with charitable remainder annuity trusts.⁴⁵ A clause similar to the following would satisfy this requirement:

If the net fair market value of the Trust assets is incorrectly determined, then within a reasonable period after the value is finally determined for federal tax purposes, the Trustee shall pay to the Donor (in the case of an undervaluation) or receive from the Donor (in the case of an overvaluation) an amount equal to the difference between the annuity amount properly payable and the annuity amount actually paid.⁴⁶

The regulations neither require nor explicitly permit interest to be paid on required adjustment payments.

If the value of the initial transfer is understated, the taxpayer will not incur gift tax if the annuity is expressed as a percentage of, or fraction of, the initial fair market value of the transferred assets. When the annuity is expressed as fixed dollar amount, the value of the annuity will not be adjusted and a re-valuation will result in a gift of the amount of undervaluation. Therefore, the annuity should never be expressed in terms of a dollar amount when the value of the contribution is uncertain.

[b] *Additional Contributions to a GRAT*

The trust instrument must prohibit additional contributions to the trust.⁴⁷ This requirement is arguably inappropriate because a post-creation transfer could never adversely affect the value of the retained annuity interest and would be fully subject to gift tax. The gift tax would be imposed on the addition because it could not increase the amount of the grantor's annuity interest.⁴⁸

⁴⁵ Treas. Reg. § 25.2702-3(b)(2).

⁴⁶ This clause appeared in the trust instrument described in PLR 9239015 (June 25, 1992), discussed in Footnote No. 23, *supra*.

⁴⁷ Treas. Reg. § 25.2702-3(b)(4).

⁴⁸ The requirement is apparently modeled after the charitable remainder annuity trust's governing instrument requirement that prohibits additions to the trust after creation. Treas. Reg. § 1.664-2(b). The purpose for the charitable remainder annuity trust requirement, however, is most likely the prevention of the use of

[c] *Commutation and Sales*

The trust instrument must prohibit “commutation.”⁴⁹ By this term, the regulations refer to the pre-payment by the trustee of the annuitant’s annuity interest. This requirement is also arguably inappropriate because a commutation clause requiring that the pre-payment amount equal to the then actuarial value of the annuitant’s remaining annuity payments could not be used to reduce the value of the annuitant’s interest in the trust.⁵⁰

It is likely that the Service’s reason for prohibiting commutation was to prevent termination of a GRAT at a time when the grantor’s life expectancy was short. As discussed below, if a grantor dies during the term of her GRAT, some portion of the trust will be included in her gross estate under Code Sec. 2036. The amount included could be reduced if the trustee could terminate the GRAT before the grantor’s death by paying the grantor an amount equal to the then actuarial value of her interest and by paying the remainder beneficiaries the balance of the trust property.

What if instead of having the trust prepay the grantor the value of the grantor’s interest, the grantor sells the interest to a third party? Is that a commutation (prepayment)? Presumably not, though the

post-creation additions to avoid Code Sec. 664(d)(1)’s requirement that the annuity be equal to at least 5% of the initial value of the trust. There is no corresponding requirement in the statutory definition of a qualified interest under Code Sec. 2702. The charitable lead annuity trust regulations do not contain a similar requirement, and there is no reason to impose one either for charitable lead annuity trusts or for GRATs. *See* PLR 9506001 (September 28, 1994) in which the Service conceded that there is no prohibition against additional contributions to a charitable lead trust and that the grantor of a GRAT created prior to the issuance of the regulations could have reasonably inferred from this fact that there would be no prohibition against additions to a GRAT. As a result, the Service ruled that the GRAT provided its grantor with a qualified interest despite the absence of a prohibition against additions.

⁴⁹ Treas. Reg. § 25.2702-3(d)(4). *See* PLR 9412036 (December 23, 1993) in which the IRS determined that the absence of a provision prohibiting commutation would preclude treatment of an interest as a qualified interest.

⁵⁰ This provision is reflective of a similar, arguably erroneous, position that the Service has taken in the charitable lead trust area. In Rev. Rul. 88-27, 1988-1 C.B. 331, the Service concluded that a trustee’s right to prepay annuity amounts disqualifies a trust for treatment as a charitable lead trust since the prepayment possibility makes it impossible to determine the amount of each annuity payment at the outset of the trust. *See* GCM 39676 (October 30, 1987).

IRS might not agree with this conclusion. This issue is discussed later in this article.

Although commutation is prohibited, there are no governing instrument requirements in the regulations that require the GRAT to explicitly preclude a sale of the annuity. However, Treas. Reg. § 25.2702-3(b)(1) states:

The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest at least annually.

More importantly, perhaps, Treas. Reg. § 25.2702-3(d)(2) provides:

The governing instrument must prohibit distributions from the *trust to or for the benefit of any person other than the holder of the qualified annuity or unitrust interest during the term of the qualified interest.* (Emphasis added.)

The proper interpretation of the prohibition against commutation should be that the Trustee herself cannot pay off the income interest which would, in effect, terminate the arrangement prematurely. If the Grantor's continuing interest is terminated externally, rather than internally, this should not be a commutation since the split interest arrangement is continued until the last annuity is finally paid.

[d] *Amounts Payable to Other Persons*

The trust instrument must prohibit payments from the trust before the expiration of the qualified interest to or for the benefit of any person other than the annuitant.⁵¹ The charitable lead trust regulations contain a similar provision.⁵²

[e] *Term of the Annuity*

The term of the qualified annuity interest must be fixed in the trust instrument and must be for (i) the life of the annuitant, (ii) a specified term of years, or (iii) the shorter of those two periods.⁵³

These requirements are not imposed by the statute. Code Sec. 2702(b)(1) does not impose any limitations on the period over

⁵¹ Treas. Reg. § 25.2702-3(d)(2).

⁵² Treas. Reg. § 25.2522(c)-3(c)(2)(vi)(f).

⁵³ Treas. Reg. § 25.2702-3(d)(3).

which the fixed amounts are payable. The regulations' requirements as to the permissible term of a GRAT differ from the corresponding charitable lead trust requirements⁵⁴ in two respects. First, the charitable lead trust regulations do not require that the measuring life or lives be the life or lives of individuals who have interests in the trust. Until recently, the measuring life could be any life at all. There was no requirement that the individual have any relationship to the trust, the donor, or the trust beneficiaries. Recently issued final Treasury Regulations, which generally apply to transfers to inter vivos charitable lead trusts made on or after April 4, 2000⁵⁵, provide that the permissible term for guaranteed annuity interests and unitrust interests is either a specified term of years, or the life of certain individuals living at the date of the transfer. Only the donor, the donor's spouse, and an individual who, with respect to all remainder beneficiaries (other than a charity) is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries may be used as measuring lives.⁵⁶

Second, the charitable lead trust regulations permit a trust to be measured by a life or lives *plus* a number of years.

The GRAT regulations contain one example that is inconsistent with the regulations' general rule characterizing an annuity payable over a term of years as a qualified interest. Treas. Reg. § 25.2702-3(e), Example 5⁵⁷ provides as follows:

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. A's interest is a qualified unitrust interest

⁵⁴ Treas. Reg. § 25.2522(c)-3(c)(2)(vi)(a).

⁵⁵ Treas. Reg. §§ 1.170A-6(e); 20.205-2(e)(3)(iii); and 25.2522(c)-3(e). The regulations provide for certain exceptions to the effective date.

⁵⁶ Treas. Reg. §§ 1.170A-6(c)(2)(i)(a) and (ii)(a); 20.2055-2(e)(2)(vi)(a) and (vii)(a); and 25.2522(c)-3(e)(2)(vi)(a) and (vii)(a). A trust will satisfy the requirement that all noncharitable remainder beneficiaries are lineal descendants of the individual who is the measuring life, or that individual's spouse, if there is less than a 15% probability that individuals who are not lineal descendants will receive any trust corpus.

⁵⁷ Note that example 5 was ruled invalid by *Walton, infra*, and that the Service has acquiesced in that decision. Notice 2003-72, 2003-44 IRB, 10/15/2003.

to the extent of the right to receive the unitrust payment for 10 years or until A's prior death.⁵⁸

The effect of this example, if correct, would be to reduce the value of A's 10-year annuity to the value of an annuity payable until the earlier to occur of her death or the expiration of the 10-year period. Under Example 5 (just quoted), the portion of the retained interest that represented the death contingency is treated as something other than a "qualified interest." It follows, somewhat bizarrely, that the interest passing to the estate of the grantor would "be treated as" a gift to the remainder beneficiaries.

Example 5 is also inconsistent with two other examples that also appear in Treas. Reg. § 25.2702-3(e). Both Examples 2 and 3 characterize annuity payments made over a term of years as qualified interests with no limitation related to the life span of the annuitant.⁵⁹ In Example 2, U transfers property to an irrevocable trust and retains the right to receive \$10,000 per year in the first three years, \$12,000 per year in the next three years, and \$15,000 per year in the next four years. The example concludes that U's interest is a qualified annuity interest in each of the ten years except that the interest in year seven is qualified only to the extent of \$14,400 because of the 120% limitation on year-to-year annuity increases. Similarly, Example 3 concludes that S's right to receive \$50,000 in each of the first three years of her trust and \$10,000 in each of the next seven years is a qualified annuity interest in its entirety.

In December 2000 a unanimous Tax Court held in *Walton v. Commissioner* that Example 5 is invalid.⁶⁰ The Tax Court concluded in *Walton* that Congress intended to permit a grantor to retain qualified annuity interests for a specified term of years, that the appropriate method for doing so is to provide that the balance of any payments due after the grantor's death should be payable to her estate, and that Example 5 is an unreasonable and an invalid extension of Code Sec. 2702. The government argued in *Walton*

⁵⁸ The example describes a grantor retained unitrust rather than a grantor retained annuity trust. The requirements as to the term of the qualified payments are the same for both types of trusts.

⁵⁹ See also Treas. Reg. § 25.2702-2(d), Examples 6 and 7.

⁶⁰ *Audrey J. Walton v. Commissioner*, 115 T.C. 589 (2000), acq. Notice 2003-72, 2003-44 IRB, 10/15/2003.

that Mrs. Walton had created the following three separate interests in her GRATs: (1) an annuity payable to her for the shorter of her life or two years, (2) a contingent annuity payable to her estate if she died within the two-year period, and (3) a remainder interest payable to her daughters. Of the three interests, only the first one, in the view of the Service, constitutes a qualified retained interest within the meaning of Code Sec. 2702. The Tax Court disagreed. It focused on the historical unity between an individual and her estate and concluded that even if the GRAT instrument did create separate interests in favor of Mrs. Walton and her estate, both interests must be considered as retained by her since it is axiomatic that an individual cannot make a gift to herself or her estate. The Service permitted the period of time to file an appeal from the *Walton* decision to elapse without filing an appeal. The Service recently acquiesced in the *Walton* case and announced that it was withdrawing Treas. Reg. § 25.2702-3(e), Ex. (5).⁶¹ One presumes that Ex. 5 will either be amended or excised entirely from the regulations.

§ 27.03 GIFT TAX ASPECTS

[1] In General

Code Sec. 2702(a)(2)(B) provides that the value of a qualified annuity interest will be determined under Code Sec. 7520. This means that the value of a gift to a trust in which the grantor has retained a qualified annuity interest will be determined by subtracting from the value of the property transferred to the trust an amount equal to the actuarial value of the retained annuity.⁶² Consider the following example:

Example 6: Jennifer transferred \$1,000,000 to a trust to pay her \$100,000 per year for 10 years. At the end of the annuity term,

⁶¹ Notice 2003-72, 2003-44 IRB, 10/15/2003.

⁶² Although the Code appears to require the use of a mechanical formula to determine the value of the retained annuity, the Service may have signaled its intention to attempt to impose a different approach. In PLR 9248016 (August 31, 1992) it observed that the value of a retained annuity interest is no greater than the present value of the right to receive the annuity payments until the fund is exhausted and that "[T]he exercise of unusual trustee discretion (e.g., the power to invest in highly speculative assets without regard to the preservation of corpus) would substantially increase the possibility of loss with respect to the fund." See also PLR 9444033 (August 5, 1994).

the trust property is required to be paid to her son Patrick. At the time she created the trust, the Code Sec. 7520 rate was 4%. The actuarial value of her right to receive \$100,000 per year for 10 years is \$811,090.⁶³ The amount of her gift to Patrick is \$188,910, the excess of \$1,000,000 over the value of her annuity interest.⁶⁴

However, in determining the actuarial value of an annuity, the annuity is not deemed payable for the entire period if, using the Code Sec. 7520 rate, the trust funds would be exhausted before the last annuity payment is to be made.⁶⁵ For this purpose, measuring lives must be deemed to survive to 110 years of age.⁶⁶

Example 7: The facts are the same as in Example 6 except that Jennifer, who is 50 years of age, retains an annuity payable for life rather than for a 10-year term. If Jennifer survived to age 110, the annuity may continue for 60 years. The actuarial value of the right to receive \$100,000 per year for 60 years is \$1,237,660. Since the present value of an annuity for a term of 60 years exceeds the corpus, the annuity may exhaust the corpus before all payments are made. Thus, the annuity must be valued as if payable for a term of years equal to the number of years

⁶³ The formula for calculating the value of an annuity payable for a term of years is as follows:

$$V = \frac{x}{i} \left[1 - \frac{1}{(1+i)^n} \right]$$

In this formula, "x" equals the annuity amount (\$100,000 in Example 7); "i" equals the Code Sec. 7520 rate (4% in the example); "n" equals the number of years the annuity is to be paid (10 years in the example), and "V" equals the value.

For discussions of the derivation of this formula (and similar formulas) see Schmolka, "Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty-Six Years of Astigmatism," 40 Tax L. Rev. 1 (1984); Caulfield, "The Mathematics of Partial Interests in Property," 6 Probate & Property (November/December 1992) 44.

⁶⁴ The valuation conclusion reached in this example assumes that Treas. Reg. § 25.2702-3(e) Example 5 is incorrect, as suggested above. If Example 5 is correct, the value of Jennifer's gift would be the same as the value determined in Example 9 in the text.

⁶⁵ Treas. Reg. § 25.7520-3(b)(2)(i). Rev. Rul. 77-454, 1977-2 C.B. 351.

⁶⁶ Treas. Reg. § 25.7520-3(b)(2)(i).

in which the fund is projected to be exhausted or the prior death of the annuitant. If the trust property generates income and appreciation of 4% per year, the trust will be able to pay Jennifer \$100,000 per year for only 13 years and will be able to make a final payment of \$2,485 at the end of the 14th year. The value of Jennifer's retained interest is the sum of the present values of these two amounts. The right to receive \$100,000 per year for the shorter of 13 years or the life of a 50 year old individual has a present value of \$957,460. The right to receive \$2,485 at the end of 14 years if a 50 year old individual is alive has a present value of \$1,265. The sum of the two is \$958,727. The amount of Jennifer's gift to Patrick, therefore, is \$41,273.⁶⁷

The value of the retained interests in a GRAT will generally increase as the Code Sec. 7520 rate decreases. This is so because a decrease in the deemed rate of current return will tend to make the right to receive fixed amounts in the future more valuable. This is the opposite of a GRIT or QPRT.⁶⁸ Why is that?

First, note that what we are looking for is the sum of money needed to produce x amount at the end of the term if it grows at the § 7520 rate. This initial sum of money is the true value of the gift. It is obviously true and fundamental to the analysis that the more the grantor receives, the less the value of the remainder. And yet, the lower the § 7520 rate, the greater the value of the retained interest under a GRAT, and the greater the value of the retained interest under a GRIT (including a QPRT). Clients sometimes consider this a paradox needful of further explanation. At the risk of further obfuscation, perhaps, an attempt to illuminate the valuation question follows.

The more the grantor receives, the less the remainder beneficiaries receive. This is easily comprehended. . It is equally easy to understand that if interest rates are high, and if the grantor is receiving "all of the income," the value of the grantor's interest is greater than if interest rates are lower. This is because what the grantor receives is relative to the prevailing interest rate. What has just been described is what the grantor retains in a GRIT.

⁶⁷ Treas. Reg. § 25.7520-3(b)(2)(v) Example 5; Rev. Rul. 77-454, 1977-2 C.B. 351.

⁶⁸ Qualified Principal Residence Trust.

Unlike the beneficiary of an income interest, the beneficiary of a fixed annuity (the grantor of a GRAT) receives an amount that bears no direct relationship to the prevailing rate of return. The only function that the prevailing rate of return (represented by the Sec. 7520 rate) plays in the equation is in ascribing value to the annuity. Unlike an income interest, the annuity under a GRAT is fixed. It is what it is, regardless of the Sec. 7520 rate. What the beneficiary receives is not tied to the Sec. 7520 rate at all.

The value of what the annuitant/beneficiary receives is another matter entirely. The greater the current assumed rate of return, the less the value of an annuity that is fixed absolutely in a manner not tied to the prevailing Sec. 7520 rate. The analysis is similar to the bond market. If the prevailing interest rate for bonds is 5% and you own a 10% bond, your 10% bond is worth more than it would be if the prevailing interest rate for bonds were 15%. It follows that in a GRAT—which, like most bonds, pays a flat rate—the greater the assumed rate of return (represented by the Sec. 7520 rate), the greater the gift tax value of the remainder, which is the converse of the GRIT or QPRT.

Thus, if interest rates are low, a retained annuity is worth more than it would be if interest rates were higher. Accordingly, the lower the § 7520 rate, the less size of the taxable gift, and that is what is desired in a GRAT.

To the contrary in a GRIT, of which a QPRT is a species. In a GRIT, the lower the prevailing rate of return (represented by the Sec. 7520 rate), the less the value of the retained income interest (which in a QPRT is represented by the right to live in the home), and the value of the gift of the remainder is commensurately greater.

The table below shows the effect of changes in the Code Sec. 7520 rate on the amount of the taxable gift attributable to the creation of a 10-year GRAT with a required annuity equal to 12.33% of the initial value of the trust property.⁶⁹

⁶⁹ The table assumes that Treas. Reg. § 25.2702-3(e) Example 5 is invalid.

Code Sec. 7520 Rate	Value of Retained Interest as % of Property Transferred	Value of Gift as % of Property Transferred
4.00%	100.00%	0.00%
5.00%	95.20%	4.80%
6.00%	90.74%	9.26%
7.00%	86.59%	13.41%
8.00%	82.73%	17.27%
9.00%	79.12%	20.88%

[2] Spousal Annuities

A qualified annuity payable to the husband of the grantor will be treated as an annuity retained by the grantor if she has retained the power to revoke it.⁷⁰ For example, suppose that Jennifer, the grantor described in Example 6, had directed the trust to pay the \$100,000 per year to her husband John rather than to her and that she had retained the power to revoke the annuity. If the trust provisions otherwise satisfy the governing instrument requirements discussed above, John's annuity will be treated as having been retained by Jennifer.⁷¹

The gift tax consequences of a life-time exercise by a grantor of her power to revoke a spousal annuity are unclear. Such a revocation could be treated as a transfer of an interest in the GRAT. The value of the interest transferred would be the then actuarial value of the spouse's right to receive the annuity amount if the grantor died during the term and the spouse survived.⁷²

⁷⁰ Treas. Reg. § 25.2702-2(a)(5); Treas. Reg. § 25.2702-2(d)(1) Example 7. Compare Treas. Reg. § 25.2702-2(d)(1) Example 3, illustrating that neither the grantor nor her spouse has "retained" an annuity where the annuity is payable to the spouse but the grantor retains no power of revocation.

⁷¹ The Tax Court ruled in *Cook v. Commissioner*, 115 T.C. 15 (2000), *aff'd*, 269 F.3d 854 (7th Cir. 2001), and again in *Schott v. Commissioner*, 81 T.C.M. 1600 (2001), that the spousal annuity rule was not available for spousal annuities that were contingent on the spouse's survival of the grantor and on the grantor's death prior to the expiration of a term of years. The Ninth Circuit reversed the Tax Court's decision in *Schott* (*Schott v. Commissioner*, 319 F.2d 1203 (9th Cir. 2003)). It held that an annuity payable for the lives of the grantor and her husband or 15 years, if less, is as qualified as the annuity described in Example 7.

⁷² Cf. PLR 9451056 (September 26, 1994), in which the Service states that a spouse's revocable annuity is a qualified annuity interest retained by the grantor only if it is not revoked.

In light of the IRS' acquiescence in *Walton*,⁷³ this issue is irrelevant for prospective planning purposes, since payment to the grantor's estate can achieve an even better result, because the grantor's mortality is not a factor that need be considered. Since there are still a number of GRATs existing that contain the revocable contingent annuity feature, an extended discussion of this abstruse issue is perhaps still in order.

This is a complicated issue. It is also one in which the Service has reversed itself.⁷⁴ The idea springs from Treas. Reg. § 25.2702-2(a)(5), second (and last) sentence. "Retention of a power to revoke a qualified annuity interest⁷⁵ (or unitrust interest) of the transferor's spouse is treated as the retention of a qualified annuity interest (or unitrust interest)."⁷⁶ This is a very puzzling and peculiar rule, and what it means exactly has been the subject of much uncertainty.

Recall that the rules under § 2702 do not apply to a GRIT for a spouse, if the grantor retains no interest. "Section 2702 does not apply because neither the transferor nor an applicable family member has retained an interest in the trust."⁷⁷

It appears, given the Service's evolving/changing position, that the spouse's interest can qualify if the grantor has retained a predecessor interest, if the spouse's interest is not contingent on surviving the grantor. The contingency that it may be revoked is another matter, and seems to be required, which is one reason that this whole area remains a mystery, at least to some.

A power to revoke an interest in a spouse is not something mentioned in the statute, but it is mentioned in the regulations, and it has caused much confusion, to many, including me. Two examples in the regulations address this issue:

Example (6). A transfers property to an irrevocable trust, retaining the right to receive the income for 10 years. Upon expiration

⁷³ *Walton, supra*.

⁷⁴ TAMs 9707001, 9848004 and 200230003, and *Cook v. Com.*, 269 F.3d 854 (7th Cir. 2001). Cf. PLRs 9352017 (modified by 199937043), 9451056, 9449013 (modified by PLR 199951032), and 9416009.

⁷⁵ The term "qualified interest" as used here is somewhat circular.

⁷⁶ Treas. Reg. § 25.2702-2(a)(5), second (and last) sentence.

⁷⁷ TAMs 9707001, 9848004 and 200230003, and *Cook v. Com.*, 269 F.3d 854 (7th Cir. 2001). Cf. PLRs 9352017 (modified by 199937043), 9451056, 9449013 (modified by PLR 199951032), and 9416009.

of 10 years, the income of the trust is payable to A's spouse for 10 years if living. Upon expiration of the spouse's interest, the trust terminates and the trust corpus is payable to A's child. A *retains the right to revoke the spouse's interest*. Because the transfer of property to the trust is not incomplete as to all interests in the property (i.e., A has made a completed gift of the remainder interest), section 2702 applies. *A's power to revoke the spouse's term interest is treated as a retained interest for purposes of section 2702*. Because no interest retained by A is a qualified interest, the amount of the gift is the fair market value of the property transferred to the trust.

****Example (7)*. The facts are the same as in Example 6, except that both the term interest retained by A and the interest transferred to A's spouse (subject to A's right of revocation) are qualified annuity or unitrust interests. The amount of the gift is the fair market value of the property transferred to the trust reduced by the value of both A's qualified interest and the value of the qualified interest transferred to A's spouse (subject to A's power to revoke).⁷⁸

Just how these examples are to be interpreted has never been clear. We know from Treas. Reg. § 25.2702-2(d) Example (3) that the rules under 2702 do not apply to a GRIT for a spouse, if the grantor retains no interest. We also know that the last sentence of Treas. Reg. § 25.2702-2(a)(5) states that the "[r]etention of a power to revoke a qualified annuity interest (or unitrust interest) of the transferor's spouse is treated as the retention of a qualified annuity interest (or unitrust interest)."⁷⁹ But, is it safe to say that term "qualified interest" includes the retention of a power to revoke a qualified interest of someone other than the spouse? At one time the IRS indicated as much in a private letter ruling, but it has since backed off that position. See immediately below.

Apparently, under the *Cook*⁸⁰ case (perhaps in *dictum*),⁸¹ it is fine to have a revocable spousal successor interest not contingent on surviving the grantor, but that only the grantor's single life

⁷⁸ § 25.2702-2(d) Examples (6) and (7).

⁷⁹ Treas. Reg. § 25.2702-2(a)(5), second (and last) sentence.

⁸⁰ *Cook v. Com.*, 115 T.C. 15 (2000), aff'd, 269 F.3d 854 (7th Cir. 2001).

⁸¹ This *dictum*, if that is what it was, was expressly referred to approvingly in *Walton, supra* as being good law even if Ex. 5 did not apply.

expectancy can be considered, not the joint life expectancy of the grantor and the grantor's spouse, which is only relevant if Example 5 under the Dash 3 regulation is valid. Under *Walton*,⁸² Example 5 is not valid, which may make the whole issue moot given the Service's acquiescence⁸³ in *Walton*.

On the other hand, in *Schott v. Comm'r.*⁸⁴, the Ninth Circuit reversed the Tax Court and held that the joint life expectancy of the grantor and the grantor's spouse could be used, where the GRAT was structured as a two-life annuity, where the only contingency was the right of the grantor to revoke the spouse's interest.

Note that if the power to revoke is exercised, there could be a completed gift to the remainder beneficiaries at that time. Query how the marital deduction figures in all this, if at all.

Again, after the Service's acquiescence in *Walton*, there are no obvious gift tax reasons why a married grantor would want to provide for an annuity interest in the grantor's spouse, applicable if the grantor dies during the term, which successor interest is subject to a testamentary power to revoke. In fact, if *Walton* is good law, then this may be a bad idea, since *Walton* may hinge on the unexpired term interest being payable to the grantor's estate in the event the grantor dies prior to the end of the term.

[3] Valuation Formulas

If an individual wants to give an interest in a difficult-to-value asset, such as an interest in a closely held business, the GRAT offers an opportunity to make the transfer without running a significant risk of unexpected gift tax. The gift tax risk can be reduced by the use of a formula to define the amount of the retained annuity. Consider the following example.

Example 8: Patrick owns all of the shares of the X corporation. He believes that X is worth \$1,000,000 and that a 30% interest in X is worth \$195,000, after applying a 35% minority discount. Patrick transfers 30% of the X corporation to a GRAT. The terms

⁸² *Audrey J. Walton v. Commissioner*, 115 T.C. 589 (2000), acq. Notice 2003-72, 2003-44 IRB, 10/15/2003.

⁸³ Notice 2003-72, 2003-44 IRB, 10/15/2003.

⁸⁴ *Schott v. Com.*, 319 F.3d 1203 (9th Cir. 2003), rev'g, T.C. Memo 2001-110. Compare TAM 200319001.

of the trust instrument provide him with an annuity of 12% of the initial value of the trust property payable for 10 years. At the end of the 10-year term, the trust property is to be paid to his daughter Kate. Assuming a Code Sec. 7520 rate of 4% and an initial value of \$195,000, Patrick's retained annuity is worth \$189,795. His gift to Kate will be \$5,205.⁸⁵

If the Service successfully argues that the 30% interest in the X corporation is worth \$390,000 instead of \$195,000, the value of Patrick's gift to Kate will increase only modestly. This is so because the increase will be restricted by the increase in the amount of Patrick's retained annuity caused by the GRAT's annuity formula. If the value of the stock is determined to be \$390,000, Patrick's annuity will double from \$23,400 to \$46,800. The present value of the right to receive \$46,800 per year for 10 years is \$379,590, leaving a taxable gift of only \$10,410.

In contrast, if the GRAT had defined the annuity as a flat \$23,400 (12% of \$195,000), an increase in the value of the shares transferred to the GRAT from \$195,000 to \$390,000 would have increased Patrick's taxable gift from an expected \$5,205 to \$200,205.

[4] Termination

When the annuity term ends and the remaining trust property is paid to the remainder beneficiary, no additional gift tax is imposed on the grantor. The grantor's gift was complete for gift tax purposes when the trust was created. There is no mechanism in the gift tax that permits the assessment of an additional tax in the event the assumptions on which an original valuation was made prove to be inaccurate.

If the trust property generates a total return in excess of the Code Sec. 7520 rate used to value the annuity interest when the trust was created, there will be value in the trust in excess of the portion of the original trust that was subject to gift tax. This amount will pass to the remainder beneficiaries free of gift tax. Consider the following example:

Example 9: Suppose the shares of X that Patrick gave to the trust described in Example 8 produce a total return of 10% per

⁸⁵ This example and the subsequent examples in this outline assume that Treas. Reg. § 25.2702-3(e) Example 5 is invalid, and that Treas. Reg. § 25.2702-3(e) Examples 2 and 3 are correct.

year for the 10-year term of the trust. After Patrick has received all of the annuity payments to which he was entitled, the trust property will be worth \$132,844, all of which is payable to Kate. If the property's total return had been consistent with the Code Sec. 7520's 4% rate used to value the annuity interest, she would have received only \$7,705 at the end of the trust's term.⁸⁶

Example 9 illustrates one of the most important estate planning attributes of the GRAT—it permits a transferor to shift to the objects of her bounty any portion of the future return generated on her investments in excess of the original Code Sec. 7520 rate without paying a significant gift tax.

§ 27.04 ESTATE TAX ASPECTS

[1] Gross Estate Inclusion

[a] Code Sec. 2036

If a grantor dies while she has the right to receive further annuity payments from her GRAT, some portion, or all, of the GRAT will be included in her gross estate for federal estate tax purposes under Code Sec. 2036. This section requires that a transferor include in her gross estate the value of property transferred during her life if she retained for life, or for a period that did not end before her death, the right to the income from the transferred property.

The grantor of a GRAT does not explicitly retain the right to income. Instead, she retains the right to an annuity which may be more or less than the actual income received by the trust. The Service treats this type of retained interest as if it were the right to receive the income from a portion of the trust corpus. That portion is required to be included in the gross estate. The included portion is that fraction of the corpus which would be required to be invested at the Code Sec. 7520 rate in effect on the date of the grantor's death to produce annual income equal to the required annuity payment.⁸⁷ Consider the following example:

⁸⁶ This is the amount to which the original gift portion of the trust, \$5,205, would have grown over 10 years if it had been invested at 4%.

⁸⁷ Rev. Rul. 82-105, 1982-1 C.B. 133. In this ruling the Service explicitly declined to determine the amount that might be includible in the decedent's gross estate under any other provision of the Code. However, in PLR 20021009

Example 10: John transferred \$1,000,000 to a GRAT to pay him an annuity of \$100,000 per year for the lesser of 10 years or his remaining lifetime. At the end of the trust period, the trust property was to be distributed to John's son Patrick. John died at the beginning of the 6th month during the 9th year when the trust was worth \$2,000,000 and the Code Sec. 7520 rate was 10%. John's estate will be required to include \$1,000,000 in his gross estate because \$1,000,000 would be required to be invested at 10% to produce income equal to the \$100,000 annuity.

If a GRAT is established by joint contributions made by the beneficiary of the annuity interest and by the beneficiary of the remainder, and if each has contributed an amount equal to the actuarial value of her interest in the trust, Code Sec. 2036 ought not to apply on the death of the annuitant. Code Sec. 2036 applies only if the decedent has not received adequate and full consideration in money or money's worth for her transfer.

In Private Letter Ruling 9515039,⁸⁸ the Service determined that Code Sec. 2036 did not apply in the case of such a joint purchase when the obligation to pay the annuity was guaranteed by the holder of the remainder interest who had sufficient assets, independent of her interest in the jointly purchased property, to satisfy the annuity. The Service cited Rev. Rul. 77-193⁸⁹ in support of its conclusion.

(November 19, 2001) the Service used the formula provided in Rev. Rul. 82-105 to determine the amount included under Code Sec. 2036, but then went on to determine that the entire value of the GRAT was included under Code Sec. 2039. See also *Uhl v. Commissioner*, 241 F.2d 867 (7th Cir. 1957); GCM 38625 (February 5, 1981). But see *Estate of Maria Becklenberg*, 273 F.2d 297 (7th Cir. 1959), *rev'g* 31 T.C. 402 (1958), in which the Seventh Circuit held that no part of a trust is included in the estate of a grantor who retained an annuity.

The formula for calculating the portion of the principal to be included is as follows:

$$P = \frac{A}{i}$$

In this formula, "A" equals the annuity amount, "i" equals the Code Sec. 7520 rate, and "P" equals the portion of the trust principal to be included.

For a discussion of alternate, possible approaches under Code Sec. 2036, see Gans, "GRIT's, GRAT's and GRUT's: Planning and Policy," 11 Va. Tax Rev. 761, 884-896 (1992).

⁸⁸ PLR 9515039 (January 17, 1995).

⁸⁹ Rev. Rul. 77-193, 1977-1 C.B. 273.

In that ruling, the Service had concluded that Code Sec. 2036 did not apply to a transfer of property in exchange for the personal obligation of a transferee that was not satisfiable solely out of the transferred property and the amount of which was not determined by the size of the income generated by the transferred property. In the absence of such a guarantee, however, the Service may have characterized the annuity as a retained interest in property transferred by the decedent.

[b] *Code Sec. 2033*

If the grantor has the right to receive annuity payments after her death, the correct measure of inclusion in her gross estate is unclear. Suppose, for example, that John, the grantor described in Example 10, had retained the right to receive \$100,000 per year for 10 years, whether or not he lived for 10 years. Suppose further that on the date of his death, the actuarial value of his right to receive the last annuity payment was worth \$95,346. The value of the final annuity payment should be included in his gross estate under Code Sec. 2033. To what extent does the inclusion of a portion of the trust under Code Sec. 2033 affect the amount of the inclusion under Code Sec. 2036?

There are at least three possible approaches. First, the inclusion could be limited to the larger of the two amounts. Under these facts, \$1,000,000 would be included. Second, the inclusion could be the sum of the two amounts, in this case, \$1,095,346. The third and perhaps the best approach is to determine which portion of the trust each section includes and to adjust for any double counting. In Example 10, one-half of the principal of the trust is required to be included under Code Sec. 2036 because John is deemed to have retained the right to the income from one-half of the principal. Since the final annuity payment, which is required to be included under Code Sec. 2033, could be made from either half of the trust, arguably, it should result in an additional inclusion of only half of the \$95,346 or \$47,673.

[c] *Code Sec. 2039*

In several recent private letter rulings the Service took the position that the gross estate of a decedent who died before the termination of her right to receive an annuity from a GRAT must

include the full value of the trust corpus under Code Sec. 2039(a).⁹⁰ This section requires inclusion of the value of an annuity or other payment receivable by any beneficiary by reason of surviving the deceased annuitant under a contract or other agreement under which an annuity or other payment was payable to the decedent.

The Service's application of Code Sec. 2039 to an annuity paid under a trust instrument of which the decedent is the grantor or settlor is of questionable validity. Code Sec. 2039 appears to require a "purchase" of an annuity rather than a transfer subject to a retained interest. For this reason, Code Sec. 2039(b), which describes the amount includible, limits the includible amount to the amount of the survivor's annuity (or other amount) proportionate to the amount of the "purchase price" contributed by the decedent. A grantor who transfers property to a trust in which she retains an annuity interest does not pay a purchase price for the annuity.

The use of the purchase price as the mechanism for determining the amount of inclusion suggests the necessity of a commercial or buyer-seller relationship between the decedent and the person making her annuity payments, a relationship that does not exist between the grantor of a GRAT and her trustee. The legislative history Code Sec. 2039, which was added to the Code in 1954, suggests that it was intended to codify the inclusion rule applicable to joint and survivor annuities purchased by a decedent that had developed under existing case law⁹¹ and to extend it to certain annuities purchased for a decedent by her employer.⁹² The transferor to a GRAT is not buying an annuity from her trust. She is simply making a transfer of property and retaining an interest in that property. The trustee assumes no personal obligation to make the required annuity payments to the transferor. If the trust assets are insufficient to make payment, the transferor has no claim against

⁹⁰ PLR 20021009 (November 19, 2001); FSA 200036012 (September 8, 2000); PLR 9451056 (September 26, 1994); PLR 9448018 (August 30, 1994); PLR 9345035 (August 13, 1993). The Service had earlier reached a similar result in a private letter ruling dealing with a charitable remainder unitrust. PLR 8321104 (February 24, 1983).

⁹¹ See *Commissioner v. Clise*, 122 F.2d 998 (9th Cir. 1941).

⁹² See S. Rep. No. 1622, 83rd Cong. 2d Sess. 123-124 and 470-472 (June 18, 1954).

the trustee other than possibly a claim based on a charge of imprudent management of trust assets.⁹³

If a transferor's retained annuity interest is assumed to be an annuity for purposes of Code Sec. 2039(a), the Service's position in the private letter rulings, nevertheless, should not apply to all GRATs. For Code Sec. 2039(a) to apply, not only must an annuity be payable to the decedent, but there must also be a payment to another beneficiary and that payment must be receivable by that beneficiary "by reason of surviving the decedent."

In many cases, there will be no payment from a GRAT to another on the transferor's death. The transferor's right to receive an annuity from her GRAT does not end at her death. The annuity is payable for a fixed period of time whether or not the transferor is living. If she dies during its term, the annuity continues to be paid to her estate. In this case, there is no payment to a beneficiary by reason of her surviving the decedent. Whatever the other beneficiary receives has no relationship to the timing of the decedent's death. Code Sec. 2039 seems to be inapplicable to a GRAT unless the trust either ends on the transferor's death or unless a payment is made from the trust on the transferor's death. The Service disagreed with this analysis in Private Letter Ruling 200210009.⁹⁴

[2] Reducing the Risk of Inclusion

In some cases, the risk of inclusion under Code Secs. 2036 and 2039 can be avoided by a post-transfer sale of the annuity interest to another. For example, suppose that John, the grantor described in Example 10, had sold his annuity interest to his wife at the end of the first year of the GRAT. At that time the annuity interest was worth \$576,000, and John's spouse paid him that amount. Since the sale was to John's wife, John did not recognize income on the sale.⁹⁵ When John dies, if he lives for at least three years after the transfer, no portion of the trust will be included in his gross estate. If he dies within the 3-year period, inclusion may be required under Code Sec. 2035(a), which reaches property transferred within three

⁹³ Cf. *Ray v. United States*, 762 F.2d 1361 (9th Cir. 1985); *LaFarguè v. United States*, 689 F.2d 845 (9th Cir. 1982); *Estate of Fabric v. Commissioner*, 83 T.C. 932 (1984).

⁹⁴ PLR 200210009 (November 19, 2001).

⁹⁵ Code Sec. 1041.

years of death that would have been included in the gross estate under Code Sec. 2036.⁹⁶ If John's wife dies within three years of having acquired the annuity interest, no portion of the trust should be included in her gross estate under Code Sec. 2035 since she made no transfer to the trust. The present value of the remaining annuity payments, however, would be included under Code Sec. 2033.

The Service could take the position that such a sale would result in the GRAT's annuity ceasing to qualify as a qualified interest because the annuity would no longer be payable to the original annuitant, referred to in the regulations as the "holder of the annuity interest." Such payments arguably violate the requirements in the regulations that the annuity be paid to the holder of the annuity interest⁹⁷ and that no payments be made from the trust to any person other than the holder of the annuity interest before the expiration of the qualified interest.⁹⁸ Since the appropriate time to test for qualification is at the time of the gift, this position should not affect the original transfer to the GRAT. The sale itself should not trigger the separate application of Code Sec. 2702. Although the grantor's sale to his wife is a transfer of an interest in trust within the meaning of Code Sec. 2702, immediately after the transfer, no applicable family member will have retained an interest in the trust.⁹⁹

An alternative approach is a post-transfer purchase by the grantor of the remainder interest.¹⁰⁰ For example, suppose that John, the grantor described in Example 10, purchased the remainder interest from Patrick at the beginning of the ninth year when the remainder interest had an actuarial value of \$1,909,091. John's death within the ten-year term would result in the inclusion of the full value of the trust property in his gross estate because he would own all of the trust property at his death. However, his estate would be reduced by the \$1,909,091 he paid to Patrick for the remainder interest.¹⁰¹

⁹⁶ *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961).

⁹⁷ Treas. Reg. § 25.2702-3(b)(1).

⁹⁸ Treas. Reg. § 25.2702-3(d)(2).

⁹⁹ The interest acquired by the grantor's wife is not treated as "retained" because she didn't hold it before the grantor's transfer. Treas. Reg. § 25.2702-2(a)(3).

¹⁰⁰ For another discussion of this technique, see Covey, *Practical Drafting* 5626 (April 1999).

¹⁰¹ If the purchase takes place prior to the expiration of the Code Sec. 6501 period within which gift tax assessments may be made with respect to the transfers

Patrick's sale of his remainder interest would result in his recognition of gain to the extent the value of his proportionate interest in the trust, 95%, exceeds 95% of the trust's basis in its assets.¹⁰² This result might be avoided by John's purchase for cash of all appreciated assets from the trust at some time prior to his purchase of the remainder interest from Patrick. This purchase would not result in the recognition of gain by the trust or by John if the GRAT is a wholly grantor-owned trust for income tax purposes.¹⁰³ After the asset purchase, since the trust's only asset would be cash, Patrick's basis in his remainder interest would be equal to its value. If, however, the purchase of the trust assets by John and his purchase of the remainder interest from Patrick took place within a short period of time, the Service might apply the step-transaction doctrine to recharacterize the two sales as a purchase of the remainder interest from Patrick followed by the withdrawal of the trust assets from the trust.¹⁰⁴ Alternatively, if the remainder beneficiary had been a wholly grantor trust (treated as wholly-owned by John under Code Sec. 671) rather than an individual, neither John nor the trust would have recognized gain.¹⁰⁵

[3] Impact on the Grantor's Adjusted Taxable Gifts

If the creation of the GRAT was treated in part as a taxable gift, the amount of the taxable gift will be treated as an adjusted taxable gift in calculating the grantor's estate tax base except to the extent that the GRAT is included in the grantor's gross estate. The amount of any gift taxes payable on the gift will offset the estate tax

to the GRAT, the GRAT should be left in place in order to avoid an argument by this Service that the purchase followed by a termination of the GRAT was a commutation. See Rev. Rul. 98-8, 1998-1 C.B. 541.

¹⁰² PLR 8943056 (July 31, 1989).

¹⁰³ Rev. Rul. 85-13, 1985-1 C.B. 184. *But see Rothstein v. United States*, 735 F.2d 704, 84-1 U.S.T.C. ¶ 9505 (2d Cir. 1984), in which the Second Circuit took a contrary position. See also PLR 9535026 (May 31, 1995); PLR 9352017 (September 30, 1993); PLR 9352007 (September 28, 1993); PLR 9351005 (September 16, 1993); PLR 9239015 (June 25, 1992).

¹⁰⁴ Under the step-transaction doctrine, an integrated transaction may not be broken into separate and independent steps in order to alter its tax consequences. *E.g., Commissioner v. D.E. Clark*, 489 U.S. 726 (1989).

¹⁰⁵ See authorities cited in Footnote No. 96.

calculated on the estate tax base. For example, suppose that John, the grantor described in Example 10, made a taxable gift of \$300,000 when he created the GRAT and that the gift tax payable on this amount was \$165,000. If John outlives the term of the GRAT, his adjusted taxable gifts will include the \$300,000 taxable gift and the amount of his estate tax will be reduced by a portion of the \$165,000 gift tax.¹⁰⁶

If John dies within the term of the GRAT so that some portion of the GRAT is included in his gross estate, the inclusion will eliminate some portion of his adjusted taxable gifts. This is so because Code Sec. 2001(b) defines "adjusted taxable gifts" as "the total amount of the taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent."

The amount by which a grantor's adjusted taxable gifts should be reduced, however, is not always clear. In Example 10, for example, the inclusion of one-half of the GRAT in John's gross estate should reduce his adjusted taxable gifts caused by the creation of the GRAT by one-half.

If, however, an amount was included in John's gross estate under both Code Sec. 2033 and Code Sec. 2036, as would be the case if John retained the right to receive annuity payments after his death, arguably, an amount included under Code Sec. 2033 should not reduce the amount of his adjusted taxable gifts. This is so because the amount included under Code Sec. 2033 was not the subject of a gift by John. It represents part of what was retained by him. If the third approach discussed above in connection with measuring the amount included is adopted, the aggregate amount included would be \$1,047,673. Of this amount 1,000,000/1,095,346 or \$956,477 seems to be properly attributable to the Code Sec. 2036 inclusion. Conversely, 95,346/1,095,346 or \$91,165 should be attributable to the Code Sec. 2033 inclusion. If \$956,477 is the correct amount of the Code Sec. 2036 inclusion, since this represents 47.82% of the current value of trust, 47.82% of the \$300,000 original taxable gift should be excluded from John's adjusted taxable gifts.

¹⁰⁶ Code Sec. 2001(b)(2).

[4] Estate Tax Apportionment on Donor's Premature Death

In the event that some or all of the GRAT is included in the grantor's gross estate for federal estate tax purposes, tax apportionment problems can arise if the beneficiaries of the GRAT are different from the beneficiaries of the grantor's estate.

Example 11: The terms of John's GRAT require that at the end of the GRAT term the remaining assets be paid to his son Patrick. John's will provides that all of his estate's assets be paid to his wife. If John dies before the end of the GRAT term and a portion of the GRAT is included in his estate, and if his will apportions estate taxes against his residuary estate, the additional estate taxes would be borne by the estate and paid from the assets passing to his wife; Patrick would receive the GRAT assets free of estate tax.

To avoid this result, the grantor's Will could require that death taxes payable as a result of amounts included in the estate by reason of the GRAT be apportioned pro rata among the persons who benefit from the GRAT or against the GRAT itself. This will prevent the beneficiaries under the grantor's Will from bearing a disproportionate amount of estate tax on the assets they receive.

[5] Marital Deduction

The possible application of the marital deduction should be considered in connection with the creation of a GRAT. If a portion of a GRAT is included in the grantor's gross estate, and if she is survived by her husband, the marital deduction could be disallowed for any portion of the included interest even if the transferor bequeaths her entire estate to her surviving spouse.

Suppose, for example, that the terms of the GRAT require any annuity amounts payable after the death of the grantor to be paid to the grantor's estate and that, under the grantor's will, these payments are to be made to the surviving spouse. Since the trust will end in favor of the remainder beneficiaries, the annuity payable to the surviving spouse will be a nondeductible terminable interest.¹⁰⁷ To avoid this result, the GRAT might give the grantor a power of appointment exercisable over such portion of the trust as

¹⁰⁷ Code Sec. 2056(b).

is includible in her gross estate. She could then exercise this power in favor of her husband. If the grantor's spouse is to receive both the remaining annuity payments and the property held in the GRAT at the end of its term, the nondeductible terminable interest rule will not apply.

Alternatively, the GRAT could provide that if the grantor dies during the term of the GRAT, the surviving spouse would receive the remaining annuity payments plus all of the trust income for the rest of his life. Her executor could then elect to treat the entire trust as qualified terminable interest property.¹⁰⁸ Since the election would be applicable only to that portion of the GRAT that was includible in the grantor's gross estate, only that portion would be included in the spouse's gross estate at death.¹⁰⁹

§ 27.05 GENERATION-SKIPPING TRANSFER TAX ASPECTS

[1] In General

Code Sec. 2702's zero valuation rule does not apply for generation-skipping transfer tax purposes.¹¹⁰ The nonapplicability is not helpful from a planning point of view because, in most cases, the generation-skipping transfer tax does not apply to a transfer to a trust in which the grantor has retained an interest or, if it applies at all, applies to all trust property, no matter how fragmented its interests are. Consider the following example:

Example 12: Jennifer transferred \$1,000,000 to a trust to pay income to herself for 10 years, remainder to her granddaughter Kate. The amount of Jennifer's gift to Kate will be \$1,000,000 under Code Sec. 2702. For generation-skipping transfer tax purposes, however, the gift will be treated as a gift to a trust rather

¹⁰⁸ Code Sec. 2056(b)(7).

¹⁰⁹ Code Sec. 2044.

¹¹⁰ The explanation that accompanied the regulations when proposed clearly so states: "Although [sections 2701 and 2702] apply to determine the amount of the gift, they do not change the value of the property for other tax purposes. Thus, in general, sections 2701 and 2702 do not apply for purposes of the generation-skipping transfer tax." 56 Fed. Reg. 14321, 14322 (April 9, 1991). Neither the final regulations nor the explanation accompanying them take a contrary position. See Explanation preceding final regulations, 57 Fed. Reg. 4250, 4251 (Feb. 4, 1992).

than to Kate.¹¹¹ As a result, no generation-skipping transfer tax will be imposed until the termination of Jennifer's interest in the trust. On the termination of the trust, however, the full value of the trust will be subject to generation-skipping transfer tax.

The result described in Example 12 applies to GRATs as well as to retained income interests. As a result, on the termination of an annuitant's interest in a GRAT, if the trust property is paid to or held for a skip person, such as the grantor's grandchild, the property will be subject to the generation-skipping transfer tax.

To avoid this result, it may be advisable to provide that the remainder interest in a GRAT be divided among the grantor's living children. If the grantor wants a deceased child's children to receive the portion of the GRAT that the child would have received if the child had survived, it is preferable to provide for such grandchildren by direct compensating gifts or by compensating bequests in the grantor's will.

Gifts and bequests to grandchildren who are children of a deceased child are preferable since they will be protected from the generation-skipping transfer tax by the so-called "predeceased parent exception."¹¹² This exception may apply to transfers from a GRAT to a grandchild but only if that grandchild's parent is dead at the time of the initial transfer to the GRAT.

If the predeceased parent exception is not available, outright gifts to grandchildren or gifts to trusts for their benefit are generally more tax efficient than transfers to grandchildren of remainder interests in trust. This is so because an outright gift is treated as a direct skip rather than a taxable termination or taxable distribution. The generation-skipping transfer tax imposed on direct skips will usually be lower than the generation-skipping transfer tax imposed on taxable distributions or taxable terminations.

If the grantor wants to designate a grandchild as the remainder beneficiary of a GRAT, the only way to protect the ultimate distribution to the grandchild from the generation-skipping transfer tax is to allocate sufficient GST exemption to the trust to result in an inclusion ratio of zero. The so called "ETIP" rule, however,

¹¹¹ See Code Sec. 2613(a)(2).

¹¹² Code Sec. 2651(e).

prevents allocation of GST exemption to a GRAT until the termination of the grantor's retained interest. Code Sec. 2642(f) prohibits the allocation of GST exemption to an inter vivos transfer if the transferred property would be included in the gross estate of the grantor (under any provision of the estate tax law other than Code Sec. 2035) if she died immediately after the transfer. The period of time during which the GST exemption allocation may not be made is referred to in the Code as the "estate tax inclusion period." The ETIP rule applies to the GRAT because if the grantor died immediately after establishing a GRAT, at least some portion of the trust property would be included in her gross estate.

Because the grantor cannot make any allocation of her GST exemption against the value of the GRAT assets passing to her grandchild until after the term of her retained interest has expired, the exemption is allocated against the value of the assets passing to her grandchild at that time, rather than at the time the GRAT was created. Accordingly, the GRAT does not create leverage that works to reduce the amount of assets otherwise subject to the GST.

[2] Techniques to Reduce the Generation-Skipping Transfer Tax

If the GRAT investments out perform the Code Sec. 7520 rate for the month the gift is made, the GRAT Technique has three significant negative features. First, if the Grantor does not survive the term, there will be estate tax inclusion as discussed in § 27.04. This risk may be hedged by the acquisition of life insurance. Alternatively, the estate tax exposure may be deferred or eliminated through the use of marital or charitable deduction planning or having a surviving spouse re-GRAT the property and survive the term. Second, the beneficial enjoyment of the transferred property by the donee is delayed until the termination of the annuity period as a condition of qualification. (See Sec. 2.01(iii)(d)). That negative feature does not occur if alternative value shifting techniques are used. Third, the Grantor cannot allocate GST exemption until the expiration of the ETIP period. Many commentators, however, believe that with proper planning, this restriction can be successfully finessed by having the remainder beneficiary either give, or sell for full value, the remainder interest.

[a] *Changing the Transferor*

It may be possible to protect a transfer to grandchildren at the end of a GRAT from the generation-skipping transfer tax by shifting the identity of the transferor with respect to the remainder interest. Suppose, for example, that the terms of a GRAT provided that the GRAT remainder would pass to a trust for the grantor's daughter and the daughter's children at the end of its term but that the daughter also had a testamentary general power of appointment over the remainder exercisable in the event the daughter died before the end of the GRAT term. If the daughter dies before the end of the GRAT term, the actuarial value of the GRAT remainder as of the date of her death will be included in her gross estate. Code Sec. 2651(a)(1)(A) provides that the transferor for generation-skipping transfer tax purposes in the case of property subject to the estate tax is the decedent in whose estate the property is taxed. The daughter's death before the end of the GRAT term will, therefore, change the identity of the transferor from the original grantor to her daughter. When the GRAT property passes to the trust for the grantor's grandchildren, there will be no generation-skipping transfer tax because the grantor's grandchildren are not skip persons as to the grantor's child.¹¹³ The Service reached this conclusion in Private Letter Ruling 200227022.

In most cases, the use of a testamentary general power of appointment will not be an acceptable approach because it could expose the daughter's estate to an unacceptably high estate tax. Suppose, for example, a 2-year GRAT was originally funded with \$1 million. Suppose the grantor's daughter died toward the end of the second year when the GRAT property was worth \$2 million and the actuarial value of the remainder interest was \$1.5 million. The daughter's estate would be subject to estate tax on the full \$1.5 million.

If a child of the grantor, rather than a trust for her benefit, is the outright beneficiary of the GRAT, the same result should be achieved if she makes a gift of her remainder interest. Code Sec. 2652(a)(1)(B) provides that the transferor for generation-skipping transfer tax purposes in the case of property subject to the gift tax is the donor. The child's gift of the remainder interest before the

¹¹³ PLR 200227022 (April 2, 2002).

end of the GRAT term should, therefore, change the identity of the transferor from the original grantor to her child.¹¹⁴ Because the child has transferred her entire interest, the ETIP rule will not apply; she has not retained an interest which would cause inclusion in her estate if she died immediately after the transfer. In Private Letter Ruling 200107015, the Service, in a situation involving a charitable lead annuity trust rather than a GRAT, concluded that the transfer of a remainder interest by a child of the grantor shifted the identity of the transferor only to the extent of the portion of the trust assets equal to the present value of the remainder interest. Although the fact pattern in the ruling was somewhat convoluted, and the transaction involved in the ruling was the transfer of a remainder interest following a CLAT, where the rules for allocating GSTT exemption are different than the ETIP rules applicable for a GRAT, the obvious lesson is that the IRS can be expected to apply the same reasoning in both to rule against the taxpayer. The Service ruled that there would be two transferors as of the date of the assignment, the remainderman with respect to the portion of the trust equal to the present value of his remainder interest and the creator of the original trust as to the balance. Thus, upon the end of the annuity term, the original transferor's interest, which generally would represent the bulk of the assets, would be subject to the GSTT. For example, if the child gifted her remainder interest in a \$1 million GRAT at a time when the remainder interest was worth only \$100,000, she would become the transferor with respect to a one-tenth interest in the GRAT.

The Service's position is based on policy, that the purpose of IRC§ 2642(e) and (f) is to prevent the use of these types of leveraging transactions to circumvent the application of the GSTT. Many commentators believe that the Service's position is technically flawed and will not withstand judicial scrutiny.¹¹⁵ It is also

¹¹⁴ PLR 200107015 (November 14, 2000).

¹¹⁵ Byrle M. Abbin, *[S]he Love Me, [S]he Loves Me Not—Responding to Succession Planning Needs through a Three-Dimensional Analysis of Consideration to be Applied in Selecting from the Cafeteria of Techniques*, 31 U. of Miami Inst. On Est. Plan. At Ch. 13 (1997), Gopman, Steinberg and S. Oshins, *Ruling on Assignment of Vested Remainder Interest May Have Reached Wrong Conclusion*, Tax Management: Estates, Gifts and Trusts Journal, (September/October 2001); See also Jerry A. Kasner, *Hot Tax Topics for Estate Planners*, Outline at 71 (April 12, 2001), where Professor Kasner states, "The IRS can't have it both ways, if

inconsistent with the Service's conclusion in Private Letter Ruling 200227022 discussed above.¹¹⁶

In order to protect against an immediate generation-skipping transfer tax on the termination of the GRAT if the Service successfully argues that the child does not become the transferor or that she becomes the transferor as to only a portion of the GRAT, the donee of the child's gift of her remainder interest should be a trust for the benefit of the child's children, and the trust should be structured so that it is a non-skip person as to the original transferor. Non-skip person status could be accomplished, for example, by including the child's spouse or her siblings as additional trust beneficiaries. If the donee is a non-skip person as to the original transferor, no generation-skipping transfer tax will be imposed when the GRAT remainder is paid to that donee.

In such instance, the trust should also contain language which would enable the transfer tax to be converted from a generation-skipping tax to an estate tax by use of a general power of appointment if the issue is ultimately resolved in favor of the Service. Conversion would be desirable if it is anticipated that the federal and state estate tax that would be imposed on value of the trust at the death of the beneficiary would be less than the generation-skipping transfer tax that would be imposed at her death. Although

the child is deemed to have made a gift, the child would now be the transferor, and the father cannot also be the transferor—the rule is the last transferor for gift or estate tax purposes is the transferor for GST purposes." See also *The Practical Practitioner*, Estate Planning Magazine, Sept. 2001 at p 448 which discusses the gift or sale of a GRAT remainder interest to a Dynasty Trust where the authors state "Arguably, the logic is flawed, but the IRS continues to legislate results when it does not agree with a result that otherwise fits within the statute. If the sale route were chosen, there does not seem to be a way to make the child a transferor of any portion of the trust, but that might mean the IRS would simply say that the whole interest is subject to GST tax upon termination of the annuity interest. Again, this seems like the wrong result. If the exempt trust had held on to the assets it used to pay for the annuity, those assets and any appreciation on those assets would have escaped GST tax.

¹¹⁶ The inconsistency may be explained by the Service's reliance in Private Letter Ruling 200107015 on Code Sec. 2642(e), a section that applies only to charitable lead annuity trusts. This subsection, in the view of the Service, was enacted to ensure that generation-skipping transfer tax would be imposed on transfers from a charitable lead trust to its creator's grandchildren unless GST exemption were allocated to the trust.

there are several ways to accomplish this conversion, such as authorizing an independent trustee to give (and take away) general powers of appointment, the use of the Delaware Tax Trap and by use of a formula provision, we favor the use of a formula provision until the issue is resolved. The formula provision has the advantage of being self adjusting pending resolution of the issue. The alternative techniques require an act which would cause estate tax inclusion which would be counter-productive if the remainder interest transfer was successful in avoiding the generation-skipping transfer tax.

[b] *Sale or Gift of the Remainder Interest to a Trust that is Exempt from the Generation-Skipping Transfer Tax*

Many practitioners believe that an estate owner's inability to use generation-skipping leveraging with the GRAT technique can be finessed by having the remainder beneficiary either gift or sell her remainder interest to a dynastic trust a reasonable amount of time after the GRAT is set up.¹¹⁷ In other words, there is the general belief that a gift or sale of the GRAT remainder interest will sever the link between the original Grantor and the dynastic trust for GST tax purposes.

For instance, if at the time of the creation of a GRAT, there is already in existence a trust for the grantor's grandchildren that has been protected from the generation-skipping transfer tax by the allocation of her GST exemption, and if the GRAT remainder beneficiary is a separate trust, the GRAT remainder beneficiary could sell its remainder interest to the protected trust. The sale, so long as the price paid is equal to the then value of the GRAT remainder interest, computed with reference to Code Sec. 7520, should not be treated as an addition from the unprotected trust to the protected trust. As a result, when the GRAT remainder is paid to the protected trust, the transfer should not be subject to generation-skipping transfer tax.

Even if there is no GST exempt trust then in existence, there appears to be no proscription as to the creation of a new trust, although the Service would have a better chance to prevail on the

¹¹⁷ Adams, Roy M., *Proprietary Approaches for Planning with Individuals and Their Businesses*, Teleconference Services at 13, (March 27, 2001).

theory that it was all a part of a single integrated transaction, or a form over substance theory.

If the remainder beneficiaries are the then living children of the grantor, each such child could chose to sell, give or retain their respective contingent remainder interest, presumably subject to a valuation reduction based upon the chance that such child will not survive the term. If the remainder beneficiary was the child if living or her estate, each child would have a vested interest subject to disposal.

The use of a trust as the remainder beneficiary of the GRAT has the advantage of allowing the planner to avoid recognition of gain on the sale by structuring the remainder trust and the GST exempt trust as grantor trusts as to the same person¹¹⁸ or grantor trust where spouses are treated as the owner of the trust.¹¹⁹ In drafting a GRAT in contemplation of the possible sale or gift of the remainder interest, it is important to be sure that the spendthrift clause is drafted in a manner which will not preclude such a transaction.

[c] *Planning—Sale or Gift*

If it is concluded that the IRS analysis in Private Letter Ruling 200227022 is incorrect, there are various alternatives that may be used to implement the remainder interest transfer. The first issue is whether to design the transfer as a gift or a sale. If the transfer is by sale, the equality of the consideration received is an issue and is of utmost importance if the sale is to a trust where the remainderman/beneficiary is a trustee and/or beneficiary of the trust receiving the remainder interest. In order to avoid a gift by the GRAT remaindermen to the dynastic trust, the purchase price paid by the dynastic trust should be the fair market value of the remainder, as determined under IRC§ 7520. If the sale is for less than adequate consideration and the remainderman is a beneficiary of the acquiring trust there would be estate tax inclusion under IRC§ 2036(a), and if the remainderman was the trustee under IRC§ 2038.

A sale will also create income tax exposure unless it is made to a trust that is defective as to the seller (or seller's spouse) if an individual or if a trust is the seller, both trusts are grantor trusts

¹¹⁸ Rev Rul 85-31, 1985-1 C.B. 184.

¹¹⁹ Code Sec. 1041

as to the same person or that person's spouse. A sale will not require the use of the seller's GSTT exemption or unified credit. If the gift route is used, the transferor will be required to use GSTT exemption to protect the continuation of GSTT exemption. The gift route would prohibit the transferor from being the trustee or a beneficiary of the recipient trust. A sale is safer than a gift with regard to avoiding a "step-transaction" argument by the IRS since two gifts followed closely in time may be recast as one gift with the initial donee serving as the straw man.

[d] "*Remainder Equivalent*" Transfer

Although most estate planners believe that the Service's analysis is misplaced, an alternative concept which should be considered is the transfer of a "remainder equivalent" rather than the remainder interest itself. That course of action would produce similar economic result with less risk¹²⁰

The transaction is described as follows:

Specifically, the remaindermen of the GRAT should contractually agree to pay the dynasty trust the value of any amount the remaindermen received from the GRAT on account of their remainder interest (that is to say, the trust purchases what we call the "remainder equivalent"). Upon termination of the GRAT term, the original remaindermen (who might be, for example, the children or a trust for their benefit) receive the property and, pursuant to their agreement with the GST exempt dynasty trust, pay an equal amount to the dynasty trust. Thus, no direct transfer occurs between the GRAT and the dynasty trust and no taxable termination occurs. Moreover, the spendthrift cause in the GRAT does not need to be modified. Rather than the dynasty trust buying the remainder interest and becoming a substitute beneficiary of the GRAT, the dynasty trust merely makes a contractual investment with the remaindermen, with the hope that it turns into something valuable.¹²¹

¹²⁰ See David A. Handler and Steven J. Oshins, "*The GRAT Remainder Sale*," *Trust and Estates*, Dec. 2002 at p. 33, for an excellent discussion of this alternate strategy as well as the planning for differing AFR rates.

¹²¹ *Id.* at p. 36-37.

§ 27.06 INCOME TAX ASPECTS

[1] The Grantor Trust Rules

The grantor trust rules¹²² generally apply to trusts that are required to or are permitted to pay trust income and principal to their grantors. Such a trust is usually referred to as a "grantor trust." A trust may be a grantor trust in whole or in part. If a trust is *wholly* a grantor trust, all of its items of income, deduction, and credit are taken into account by the grantor in calculating her taxable income and credits.¹²³ This means that the grantor who receives a distribution from a grantor trust will not be taxed on the distribution itself. Instead, she will be taxed on trust income whether or not it is distributed to her.¹²⁴ In addition, transactions between the trust and its grantor are generally ignored for all income tax purposes.¹²⁵

¹²² Code Secs. 671 through 679.

¹²³ Code Sec. 671.

¹²⁴ The Service in a 1994 private letter ruling seems to have taken the position that a grantor who pays income tax on trust income that is taxable to the grantor under the grantor trust rules would be treated as having made an additional gift to the trust equal to the amount of the taxes unless the trust were required to reimburse the grantor for the taxes paid. PLR 9444033 (August 5, 1994). Similarly, in a more recent private letter ruling, it was observed that a clause requiring a trustee to reimburse the grantor for taxes paid on trust income "relieves the grantor from paying a liability that actually belongs to the trust." PLR 9504021 (October 28, 1994). These conclusions are clearly contrary to the Code and are not supported by either regulation or case law. A grantor who pays income taxes he or she is required to pay under the grantor trust rules is simply discharging a personal obligation imposed by the federal income tax law. This obligation was never an obligation of the trust. Consequently, it cannot be treated as a direct or indirect transfer to the trust. Cf. Treas. Reg. § 25.2511-1(d), which provides that a spouse who pays all of the income tax liability for a year in which she files a joint income tax return with her husband or who pays all of the gift taxes imposed on a gift with respect to which a Code Sec. 2513 election has been made does not make a gift to her husband; TAM 9128009 (March 29, 1991), in which the Service ruled that the payment by a husband of all of the gift taxes imposed on a gift with respect to which a split gift election had been made was paying his obligation and did not make a gift to his wife.

¹²⁵ Perhaps in recognition of the precarious justification for its position, the Service withdrew PLR 9444033 and released PLR 9543049 (August 3, 1995) in its place. The new ruling does not contain the language that was in PLR 9444033 regarding the grantor making an additional gift to her grantor trust upon the grantor's payment of the trust's income tax. See also authorities cited in Footnote No. 96.

There are at least three significant benefits to a GRAT and its grantor that flow from full grantor trust status:

- (1) No gain or loss is recognized when such a trust either sells an asset to or buys an asset from its grantor.¹²⁶ This principle permits a GRAT to use appreciated trust assets to satisfy its annuity obligation without recognizing gain.¹²⁷ It also permits the grantor to transfer property to the trust that is subject to debt in excess of basis, such as partnership interests with negative bases.¹²⁸
- (2) A grantor may make an interest-bearing loan to a GRAT without being required to include the interest in her gross income.¹²⁹
- (3) The trust will be permitted to hold shares in an S Corporation.¹³⁰

The extent to which a GRAT will be required to be treated as a grantor trust is not clear. If the retained annuity interest is worth more than 5% of the value of the trust, the grantor will probably be treated as the owner of the trust accounting income portion of the trust¹³¹ and may also be treated as owner of the entire trust¹³² under Code Sec. 673. Since a GRAT must permit payments out of income or corpus, including income allocable to corpus, the grantor may also be treated as the owner of the corpus portion under

¹²⁶ Rev. Rul. 85-13, 1985-1 C.B. 184. *But see Rothstein v. United States*, 735 F.2d 704, 84-1 U.S.T.C. ¶ 9505 (2d Cir. 1984), in which the Second Circuit took a contrary position.

¹²⁷ *E.g.*, PLR 9736029 (June 8, 1997); PLR 9736028 (June 9, 1997); PLR 9735034 (June 2, 1997); PLR 9625021 (March 20, 1996); PLR 9352017 (September 30, 1993); PLR 9352007 (September 28, 1993); PLR 9351005 (September 16, 1993); PLR 9239015 (June 25, 1992). In the absence of the grantor trust rules, a distribution of property other than cash to satisfy an annuity obligation of the GRAT would be a recognition event. *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940); *Suisman v. Eaton*, 115 F.Supp. 113 (D. Conn. 1953) *aff'd per curiam*, 83 F.2d 1019 (2d Cir. 1936), *cert. denied*, 299 U.S. 573 (1936).

¹²⁸ PLR 9416009 (December 30, 1993); PLR 9230021 (April 28, 1992).

¹²⁹ PLR 9510929 (February 10, 1995).

¹³⁰ Code Sec. 1361(c)(2)(A)(i). *See* PLR 9352004 (September 24, 1993).

¹³¹ PLR 9519029 (February 10, 1995); PLR 9152034 (September 30, 1991).

¹³² PLR 9551018 (September 21, 1995).

Code Sec. 677.¹³³ In three recent private letter rulings, the Service took the position that a grantor's contingent reversion in a GRAT (*i.e.*, the right to receive all of the trust's property in the event of her death before the end of the trust term) resulted in the grantor's treatment as the owner of the trust if the contingent reversion was worth more than 5% of the value of the trust at its creation.¹³⁴

Code Sec. 677(a)(1) provides that the grantor of a trust will be treated as the owner of any portion of the trust if the income from that portion may be distributed to her without the consent of an adverse party. The Service in three recent rulings took the position that Code Sec. 677(c)(1) applied to GRATs because of the possible distribution of income and corpus to the grantor.¹³⁵ In each of these rulings, however, the annuity amount was in excess of the Code Sec. 7520 rate in effect at the time of the GRAT's creation. Thus, it was reasonable to expect that corpus would be required to fund the annuity. It is unclear whether Code Sec. 677(a)(1) would apply to the corpus portion of a GRAT if the annuity amount was equal to or less than an amount equal to the Code Sec. 7520 rate in effect at the GRAT's creation multiplied by the initial value of the property transferred to the GRAT.

Because of the uncertainty whether a GRAT will be a full grantor trust and because it is likely to be desirable that it be so, the trust instrument should include a provision that will deliberately invoke grantor trust status. Giving a nonadverse trustee the power to enable the grantor or her spouse the right to borrow trust funds at a reasonable interest rate on an unsecured basis¹³⁶ or giving a trustee who is a related or subordinate party (such as a spouse or other close family member) the right to make distribution decisions

¹³³ Schneider, "Section 2702 or GRITs, GRATs and GRUTs (What Does Your Client Want?)," *The Twenty-Sixth Annual Philip E. Heckerling Institute on Estate Planning* (1992) 12-52. *See also* PLR 9444033 (August 5, 1994).

¹³⁴ PLR 9736029 (June 8, 1997); PLR 9736028 (June 9, 1997); PLR 9735034 (June 2, 1997).

¹³⁵ PLR 9451056 (September 26, 1994); PLR 9449013 (September 9, 1994); PLR 9449012 (September 9, 1994). The Service reached the same conclusion in PLR 9448018 (August 30, 1994) and in PLR 9504021 (October 28, 1994). The facts described in these rulings do not disclose the amount of the annuity. *See also* PLRs 200001013, and 200001015.

¹³⁶ Code Sec. 675(2); PLR 9525032 (March 22, 1995).

among a class of beneficiaries¹³⁷ are good choices. Neither power should increase the trust's vulnerability to transfer taxes.

A Code Sec. 675(4) power seems to be a safe choice of a provision to create grantor trust status. This provision treats the donor as the owner of any portion of a trust if certain administrative controls are exercisable by a person in a nonfiduciary capacity without the consent of a person in a fiduciary capacity. One of the administrative powers included in Code Sec. 675(4) is the "power to reacquire the trust corpus by substituting other property of an equivalent value."

In Private Letter Ruling 9224029,¹³⁸ the Service sanctioned a Code Sec. 675(4) reacquisition clause in a charitable lead unitrust. The clause gave an individual identified as "A," who was neither a fiduciary nor a person with an adverse interest, "the right at any time to acquire any property held in the Trust by substituting other property of equivalent value." As a condition to the exercise of such power, A was required "to certify in writing that the substituted property is of equivalent value to the property for which it is substituted and the trustee may independently verify such certification of value. Any dispute regarding the value of the substituted assets may be resolved in an appropriate judicial forum." The Service concluded (1) that this clause was sufficient to characterize the trust as wholly owned by the donor, (2) that A's reacquisition power would not prevent the trust from being a qualified charitable lead trust, and (3) that no portion of the trust assets would be included in the gross estate of the donor.¹³⁹ Similar conclusions were reached in several 1993 private letter rulings involving GRATs.¹⁴⁰

The most recent private letter rulings, however, cast doubt on the usefulness of a reacquisition power as a means of creating grantor trust status. The reacquisition power described in these private letter rulings were virtually identical to the one described

¹³⁷ See Code Sec. 674(c).

¹³⁸ PLR 9224029 (March 13, 1992). See also PLR 9247024 (August 24, 1992).

¹³⁹ The grantor's retention of such a power should not subject transferred property to estate tax. *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975); PLR 9227013 (March 30, 1992).

¹⁴⁰ PLR 9352017 (September 30, 1993); PLR 9351005 (September 16, 1993); PLR 9345035 (August 13, 1993).

in Private Letter Ruling 9224029. Nevertheless, the IRS, pointing to Treas. Reg. § 1.675-1(b)(4),¹⁴¹ concluded in these rulings that the question of whether the reacquisition power is exercisable in a fiduciary or nonfiduciary capacity is a question of fact that cannot be determined until the parties' income tax returns have been examined by the Director of the District where the returns are filed.¹⁴² For any taxpayers who are willing to proceed without a private letter ruling, however, it would appear that, absent contrary state law, if the grantor is not a trustee and expressly retains the substitution power in a "nonfiduciary capacity," a substitution power remains a viable means of achieving wholly grantor trust status.

[a] *Income Tax Risks on Termination of GRAT*

Several recent technical advice memoranda serve as a reminder that the termination of grantor trust status that can occur when the GRAT period terminates can be an income tax recognition event. The taxpayer described in Technical Advice Memoranda 200010010, 200010011, and 200011005¹⁴³ created a GRAT for the benefit of his nephews. The GRAT borrowed money from a third party to pay the annuity amounts. At the end of the GRAT term, the loans were outstanding. The GRAT terminated and distributed its property to trusts for the taxpayer's nephews, subject to the notes. The Service concluded that the termination of the trust should be treated as a disposition by the taxpayer for income tax purposes and that the taxpayer had an amount realized under Treas. Reg. § 1.1001-2(a) on the disposition equal to the outstanding debt. Since his basis in the property was negligible, a large portion of the amount realized was subject to income tax.

¹⁴¹ Treas. Reg. § 1.675-1(b)(4) provides as follows:

"If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration."

¹⁴² PLR 9416009 (December 30, 1993); PLR 9407014 (November 18, 1993); PLR 9352007 (September 28, 1993); PLR 9352004 (September 24, 1993); PLR 9253010 (September 30, 1992); and PLR 9248016 (August 31, 1992).

¹⁴³ TAM 200011005 (November 23, 1999); TAM 200010011 (November 23, 1999); and TAM 200010010 (November 23, 1999).

The result in the technical memoranda seems appropriate but could have been avoided or at least postponed by providing that the trusts for the nephews that received the GRAT property at the end of the GRAT term were also grantor trusts treated as owned by the taxpayer for income tax purposes.

[b] *Loss of Basis Step-Up at Grantor's Death*

If an individual retains property until death, the individuals who receive that property at her death take it with an income tax basis equal to its fair market value at the date of death.¹⁴⁴ If the property has appreciated, the basis adjustment is a valuable consequence of including the property in the individual's gross estate. If property is received from a successful GRAT, the trust property will not be included in the transferor's gross estate and there will be no basis increase at death.

If an individual's estate tax rate is likely to be higher than the income tax rate imposed on her heirs, the estate tax savings resulting from exclusion will generally more than compensate for the loss of the increase in basis. Consider the following example:

Example 13: John transferred \$1,000,000 worth of stock in the X Corporation to a GRAT to pay him an annuity of 53% for 2 years. At the end of the 2 year period, any property remaining in the trust will be paid to his daughter Kate. At the time of the transfer, the Code Sec. 7520 rate was 4% and, as a result, the value of John's gift was \$370. John's gift was protected from gift tax by his unified credit. His basis in the X stock is 0. During the term of the GRAT, the X stock appreciates at an annual rate of 15%. Consequently, at the end of the 2-year term, Kate will receive X stock worth \$183,000. Assume that her income tax rate is 15%. If she sells the X stock, she will pay an income tax of \$27,450. If John had retained it until death, he would have paid an estate tax on this amount at a 49% rate or \$89,670. The tax savings attributable to the GRAT, therefore, is \$89,670 reduced by Kate's income tax of \$27,450, or a net savings of \$62,220.

To avoid the disadvantage of the loss of basis increase, the grantor could consider purchasing the transferred asset from the

¹⁴⁴ Code Sec. 1014. If the individual's executor selects the alternate valuation date under Code Sec. 2032, the basis is the value of the property on the alternate valuation date.

GRAT immediately before the termination of the GRAT while the trust is a grantor trust for income tax purposes. The ability to have the grantor acquire low basis assets income tax free is also available where the GRAT remainderman continues as a grantor trust for income tax purposes. Under either scenario the purchase can be made without income tax consequences to the grantor or to the trust.¹⁴⁵ The grantor receives the asset back. When she dies, the basis of the asset will be increased to its then fair market value. The trust will receive cash and will not be required to pay tax on the receipt of this cash. Alternatively, consideration could be given to using a trust provision that would result in the inclusion of the trust property in the grantor's gross estate if the income tax savings attributable to the inclusion would exceed the estate tax savings of exclusion.¹⁴⁶

§ 27.07 TRANSFER TAX ADVANTAGES OF GRATs

[1] In General

The GRAT offers a virtually risk-free and an almost gift tax-free method of shifting future income and appreciation to another. If the transferred property produces a total return over the term of the GRAT in excess of the Code Sec. 7520 rate of return that was used to value the grantor's retained annuity and if the grantor outlives the term of the GRAT, property will pass at the end of the GRAT, gift tax-free, to the remainder beneficiaries. If the rate of return is equal to or less than the Code Sec. 7520 rate, the original property and all of the income it produces during the term of the GRAT will be returned to the grantor. Thus, the grantor has the entire downside economic risk of a poorly performing investment an extremely attractive result from a planning prospective. The ability to place the entire downside investment risk on the grantor is not available to the planner with alternative wealth shifting strategies such as low interest loans, installment note sales to a defective trust, private annuities, freezes under Code Sec. 2701, etc. In such instance, the donee or transferee has significant downside risk.

¹⁴⁵ *E.g.*, PLR 9239015 (June 25, 1992).

¹⁴⁶ For a discussion of this technique, see McCaffrey, *Tax Tuning the Estate Plan by Formula*, 33 Univ. of Miami Philip E. Heckerling Institute on Estate Planning, Ch. 3 (1999).

The form of GRAT that accomplishes the shift most effectively is a short-term, single-asset, low taxable gift GRAT. Consider the following example:

Example 14: Jennifer transferred \$1,000,000 worth of the shares of the X Corp. to a 2-year GRAT. Her basis in the shares was \$500,000. At the time of the transfer, the Code Sec. 7520 rate was 4%. The X Corp. has never paid a dividend. The terms of the GRAT require that she receive an annuity payment equal to 53.0% of the initial value of the trust assets as finally determined for federal tax purposes. One payment was to be made at the end of each of the 2 years. At the end of the 2-year period, any remaining trust property was to be distributed to her son Patrick.

[2] Valuation Formula

Jennifer's transfer to the GRAT, if her valuation of the shares was correct, is a taxable gift of \$370. This is so because the present value of the right to receive \$530,000 at the end of each of the next two 12-month periods is worth \$999,630. The excess of this amount over \$1,000,000, \$370, is the amount of her taxable gift.

To some individuals, the ability to define a difficult-to-value gift by means of a formula will be the most important advantage of establishing a GRAT. Other taxpayer approaches toward minimizing valuation risks by means of various types of adjustment clauses have generally been rejected by the Service. Clauses that require post-transfer adjustments in the price of a purchased asset or in the quantity of property transferred, if the value of the transferred property is later determined to be greater than the original estimate, with few exceptions, have been rejected by the courts and by the Service.¹⁴⁷

¹⁴⁷ E.g., *Ward v. Commissioner*, 87 T.C. 78 (1986); *Harwood v. Commissioner*, 82 T.C. 239 (1984); Rev. Rul. 86-41, 1986-1 C.B. 300; TAM 9309001 (Sept. 30, 1992). *But see King v. United States*, 545 F.2d 700 (10th Cir. 1976). For discussions of this issue see McCaffrey, *supra* note 116; Peterson, "Savings Clauses in Wills and Trusts," 13 Tax Mgmt. Est., Gifts & Trusts Journal 83 (1988) and McCaffrey & Kalik, "Using Valuation Clauses to Avoid Gift Taxes," 125 Tr. & Est. 47 (Oct. 1986). *But see McCord v. Commissioner*, 120 T.C. No 13 (2003), in which the Tax Court suggested that it might have honored a valuation clause if the valuation standard had been the value of the transferred property as finally determined for federal gift tax purposes.

of which is \$500,000 and the denominator of which is the value of the transferred property as finally determined for federal gift tax purposes. The other share would be composed of the balance of the transferred property. If the trust instrument requires the trustee to allocate the first share to a trust for Patrick and the second share to a GRAT which is required to pay Jennifer an annuity, defined by a formula, with a value equal to approximately the value of the second share, a decision by the Service to value the 100 shares at \$1,000,000 instead of \$500,000 will not significantly increase Jennifer's gift tax liability. Instead it will result in an allocation of half of the 100 X shares to the GRAT. The allocation of extra shares to the GRAT will result in a substantial increase in Jennifer's annuity and only a nominal increase in her taxable gift to the GRAT.

[3] The GRAT as an Estate Freeze

The GRAT serves as a type of "estate freezing device." The freeze is not complete since the grantor must receive a return at least equal to the Code Sec. 7520 rate. Any return in excess of this rate, however, passes to the remainder beneficiaries free of gift tax. The table below shows what Patrick would receive from the GRAT described in Example 14 at the end of the 2-year period using three different assumptions as to the return produced by the shares.

Rate of Return	Amount Passing to Patrick
10%	\$97,000
15%	\$183,000
20%	\$274,000

Table 3's figures are based on the assumption that the trustee transfers X shares back to Jennifer at the end of the first year to satisfy the annuity obligation. This distribution will not be an income tax recognition event to Jennifer since the trust is a full grantor trust.

The return to Patrick could be increased if, instead of distributing the X shares to Jennifer at the end of the first year, the trustee borrowed the \$530,000 necessary to pay the annuity. As discussed above, such loan should not be made by Jennifer. The regulations

provide that the right to receive an annuity payable in the form of notes does not constitute a qualified annuity interest.¹⁴⁹

If the trustee were permitted to borrow to pay the annuity and if the GRAT property produces a total return in excess of the federal short-term rate, the use of the loan would increase Patrick's return. The table below shows the increased return to Patrick attributable to the use of such a loan.¹⁵⁰

Rate of Return	Annuity funded With Distribution of X Shares	Annuity Funded With Loan	Difference
10%	\$97,000	\$141,096	\$44,096
15%	\$183,000	\$253,596	\$70,596
20%	\$274,000	\$371,096	\$97,096

[4] Advantages of Short-Term GRAT

The 2-year term offers two advantages over a longer term.¹⁵¹ First, it minimizes the possibility that a year or two of poor performance of the transferred property will adversely impact the over-all effectiveness of the GRAT. Consider the following possible 6-year growth pattern of \$1,000,000 worth of X Corp.

Year	% Growth	Value at Year End
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¹⁴⁹ Treas. Reg. § 25.2702-3(d)(5).

¹⁵⁰ The Table assumes a Code Sec. 7872 federal short-term rate of 1.68%, the short-term rate applicable in October, 2003. Alternatively, Jennifer could receive X shares in satisfaction of her annuity and use these shares to create a new short-term GRAT.

¹⁵¹ An even shorter term would be more advantageous. But in setting the trust's term, care must be taken to avoid an argument that this trust is so short that it won't be recognized for tax purposes. In addition, it might be possible to interpret Code Sec. 2702(b)(1) as requiring a period of at least two years, since it defines a qualified interest as "the right to receive fixed amounts payable not less frequently than annually." Private letter rulings have recognized the validity of two year GRATs. *See, e.g.*, PLR 9239015 (June 25, 1992). The Service has attempted to discourage the use of short-term GRATs by taking the position that it will not rule that a retained annuity interest is a qualified interest if the annuity payable is more than 50% of the initial value of the property transferred to the trust. Rev. Proc. 2003-3, 2003-1 C.B. 113 (January 6, 2003).

1	14%	\$1,140,000
2	8%	\$1,231,200
3	-15%	\$1,046,520
4	-0%	\$1,046,520
5	7%	\$1,119,776
6	10%	\$1,231,754

Suppose Jennifer had transferred her \$1,000,000 worth of X Corp. shares to a 6-year GRAT to pay her an annuity of 19.07%. Assuming a Code Sec. 7520 rate of 4%, her taxable gift would have been \$325, an amount comparable to the taxable gift incurred in connection with the transfer to the 2-year GRAT described above. At the end of the 6-year period, Patrick would receive nothing from the trust. The value of the GRAT has disappeared because of the poor performance of the shares in the third and fourth years. The better performances in the other four years were drained to make up for the poor years.

Year	% Growth	Payment to Jennifer	Value at Year End
1	14%	\$190,700	\$949,300
2	8%	\$190,700	\$834,544
3	-15%	\$190,700	\$518,662
4	0%	\$190,700	\$327,962
5	7%	\$190,700	\$160,220
6	10%	\$190,700	\$0

If Jennifer, instead, had transferred the same number of shares to three, successive 2-year GRATs over the same period of time and if the Code Sec. 7520 rate had remained the same, Patrick would have X Corp. shares worth about \$188,800 at the end of the 6-year period. He would receive \$128,800 worth of X Corp. shares from the first GRAT. These shares would be worth \$128,900 at the end of the sixth year. He would receive nothing from the second GRAT and shares worth \$59,971 from the third GRAT.

Year	% Growth	Payment to Jennifer	Value of GRAT at Year End	Payment to Pat
	FIRST GRAT			
	\$1,000,000			
1	14%	\$530,000	\$610,000	

2	8%	\$530,000	\$128,800	\$128,800
	SECOND GRAT			
	\$1,102,400			
3	-15%	\$584,272	\$352,768	
4	0%	\$352,768	\$0	\$0
	THIRD GRAT			
	\$937,040			
5	7%	\$496,631	\$506,002	
6	10%	\$496,631	\$59,971	\$59,971

The choice between a series of short-term GRATs and a long-term GRAT is not as clear as the discussion above suggests. It is possible, for example, that an increase in the Code Sec. 7520 rate between the time the first GRAT was established and the times the subsequent ones are established may outweigh the advantage of separating different years' investment experiences. Additionally, a change in tax law during the time a transferor planned to establish successive short-term GRATs might prevent the creation of some of the planned-for GRATs.

The second advantage the 2-year term has over a longer term is the reduced exposure to the risk that the grantor will die during the term. As discussed above, some portion of the trust will be included in the gross estate of the grantor if she dies while the GRAT is in effect. Each time one of a chronological series of short-term GRATs terminates and distributes its excess value to its remainder beneficiaries, the distributed amount is protected from possible inclusion under Code Sec. 2036.

[5] Advantage of Single Asset GRAT

If a grantor has more than one asset whose future return she would like to protect with the GRAT technique, each asset should be transferred to a separate GRAT. Multiple GRATs for separate assets prevent underperforming assets from diluting the effectiveness of the good performers. The principle is the same as the one that recommends use of a chronological series of short-term GRATs rather than a single long-term GRAT to maximize the advantage to the remainder beneficiaries of the years of good investment return.

Suppose, for example, that Jennifer, the grantor described in Example 13, had two assets she wished to transfer to a 2-year GRAT—\$500,000 worth of shares of the X Corp. and \$500,000

worth of shares of the Y Corp. Suppose during the 2-year term of the GRAT that the shares of X increased by 10% per year and that the shares of Y decreased by 10% per year. If Jennifer had established a single GRAT and had funded it with the shares of X and Y, at the end of the 2-year term, there would be nothing in the trust to pass to Patrick. The excess return on the X stock was needed to compensate for the poor performance of the Y stock. On the other hand, if she had established two GRATs and had funded one with the shares of X and the other with the shares of Y, Patrick would have received property worth \$48,500 at the end of the 2-year term.

[6] Advantage of Retaining an Annuity with a Value Substantially Equal to the Value of Property Transferred

The relationship between the value of the property transferred to a GRAT and the taxable gift caused by such transfer is a function of at least four elements: (1) the Code Sec. 7520 rate, (2) the number of years over which the annuity is to be paid, (3) when and how often the annuity is payable¹⁵² and (4) the size of the annuity in relation to the value of the property transferred.

The grantor has little control over the Code Sec. 7520 rate. Since the rate that will be in effect each month is announced before the end of the preceding month, it is sometimes possible to accelerate or postpone a transfer to take advantage of a more favorable rate. If the other two factors are held constant, a decline in the Code Sec. 7520 rate will produce a smaller taxable gift. But, the changes from month to month are generally not large enough to make a meaningful difference.

If the Code Sec. 7520 rate and the size of the annuity payment are held constant, the value of the annuity is increased when the number of years over which it is to be paid is increased. But, for the reasons discussed above, it is often preferable to select a short term for a GRAT.

For those grantors who are convinced of the utility of the short-term GRAT, the usual way of increasing the value of the annuity

¹⁵² Although the annuity must be payable at least annually, it may be paid more often than annually (for instance, quarterly) which will increase its value to the grantor.

(and therefore decreasing the amount of the gift) will be to increase the amount of the annuity.

As a general rule, there is no advantage to the grantor in structuring a GRAT to produce anything other than a nominal taxable gift.¹⁵³ If the grantor wants to make a taxable gift, the taxable gift should be kept separate from the GRAT. These principles can be illustrated by comparing the results of the following alternatives:

Example 15: Jennifer creates a 2-year GRAT and transfers \$1,000,000 worth of X Corp. stock to it. She retains the right to a 53% annuity. At the end of the 2-year term, the remaining trust property is to pass to Patrick. Her transfer, as indicated above, will result in a taxable gift of \$370. Jennifer also makes an outright gift to Patrick of \$1,000,000 worth of X Corp. shares. Her outright gift will result in a taxable gift of \$1,000,000. Her total taxable gifts on account of these two transfers will be \$1,000,370.

Example 16: Jennifer creates a 2-year GRAT with \$2,000,000 worth of X Corp. stock and retains the right to a 26-1/2% annuity. At the end of the 2-year term, the remaining trust property is to pass to Patrick. Her transfer to the GRAT will result in a taxable gift of \$1,000,370.

In each of Examples 15 and 16, Jennifer will be treated as having made the same amount of taxable gift.

If the shares produce a total return over the two years at least equal to the Code Sec. 7520 rate (which the examples assume to have been 4%), for example, both fact patterns produce the same value for Patrick. Assume, for example, a 10% annual growth rate. In Example 15, at the end of the two years, he will receive \$97,000 from the \$1,000,000 GRAT and his \$1,000,000 outright interest in X Corp. will have appreciated to \$1,210,000. In Example 16, he will receive \$1,307,000 from the GRAT.

¹⁵³ The Service has attempted to discourage the use of GRATs with nominal remainder interests by taking the position that it will not rule that a retained annuity interest is a qualified interest if the annuity payable annually is more than 50% of the initial value of the property transferred to the trust or if the value of the remainder interest is less than 10% of the initial value of the property transferred to the trust. Rev. Proc. 2002-3, 2002-1 I.R.B. 117 (January 7, 2002).

The low taxable gift GRAT proves its worth if the property does not grow at a rate at least equal to the Code Sec. 7520 rate. Assume a 0 growth rate. In Example 15, at the end of the two years, Patrick would receive nothing from the GRAT. He will retain his \$1,000,000 outright interest in X Corp. In Example 16, Patrick will receive only \$940,000 from the GRAT. A part of the taxable gift portion of the GRAT was used to pay the annuity. The low taxable gift GRAT approach has saved \$60,000 for Patrick.

Although the *Walton* case appears to stand for the proposition that the annuity can be structured so that it is equal in value to the transfer to the GRAT, literally producing a zeroed-out GRAT, we recommend that their should be a gift of at least a minimal amount.¹⁵⁴ A gift tax return would then be required to be filed starting the statute of limitations running on the valuation. This course of action should prevent a successful IRS attack if down the road the IRS challenges the valuation of the annuity, determines that the grantor was underpaid and the statute of limitations has run for the grantor to enforce receipt of the underpayment from the remainder beneficiary.

[7] Advantage of Using Assets with a Large Cash Flow Subject to a Valuation Discount

The use of a GRAT can be extremely effective where assets subject to a valuation discount, such as a non-controlling interest in a closely-held business, are used to fund the GRAT and the annuity payments back to the grantor are in cash or assets not subject to a discount. The benefit is particularly dramatic during periods where interest rates are low. The cash flow from the entity can be used to pay the annuity. In many instances, the cash flow will be large as compared to the gift tax value of the original transfer such that it can often sustain a relatively large annuity payout enabling the term, and the concomitant risk of estate tax inclusion, to be compressed.

¹⁵⁴ See also fn144 which suggests that a gift is recommended to preclude the Service from successfully advancing a *Proctor* argument.