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The Opportunity GRAT 'OPGRAT' Can Reward Success and Minimize Adverse Tax Risks

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An OPGRAT provides a means for a parent to fund a venture for a child and shift the upside gains to the child. At the same time, the OPGRAT offers the parent downside protection when there is a significant risk of economic failure.

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A common estate planning dilemma is how to structure a plan when a client wishes to fund a child's entrepreneurial undertaking that requires substantial "seed" money and that has a significant chance of economic failure. A variation on this theme involves a client who seeks to place an investment portfolio under the child's management as a training device, with or without the tutelage of the parent.

The common thread of both these fact patterns is the goal of providing the child with the upside benefit, while the client absorbs the significant risk of loss of principal, should the venture implode. The ideal structure for either situation would have the following characteristics:

- If the venture is successful, most or all of the economic benefit will pass to the child;
- There will be no gift or estate tax liability arising from transfers to fund the venture;
- If the venture fails, the parent will bear the economic loss, thereby depleting the parent's taxable estate;
- If the venture fails, there will be no gift or estate tax liability arising from failure; and
- If the venture fails, the parent will be entitled to income tax deductions, especially where the parent is in a higher income tax bracket than the child.

The use of a grantor retained annuity trust, or "GRAT," can accomplish all these objectives.

These situations are distinguishable from the more common fact pattern where there is a shifting of an opportunity to generate wealth that has a reasonably predictable chance of success or one that requires negligible "seed" money.

Example. Assume Child has a business opportunity that requires a $1 million investment. The business might be a new venture or the acquisition of an existing business. Parent is willing to provide the funds, recognizing the possibility that the venture may fail.

This article examines the consequences of various wealth-shifting techniques if the venture succeeds, as well as if the venture fails. We believe that the Opportunity Grantor Retained Annuity Trust ("OPGRAT") will marry (1) the benefit of vesting ownership of "home run" results in the child and (2) the advantage of protecting the parent against adverse tax consequences of funding in the event of economic failure.

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Alternative solutions

When a parent deems it appropriate to provide funding for a child's entrepreneurial venture or real-life education in investment or business management, that funding has often taken one or more of several forms:

- Gifts.
- Loans (to the child or to an entity that will own and operate the venture).
- Loan guarantees.
- Equity investments.

Often, high risk is present in educational or entrepreneurial ventures. Should losses occur, each of the above forms of funding can potentially be harmful from both a tax and economic perspective. Therefore, selecting the right structure for the funding is imperative.

If the venture fails, it is important that the parent (and not the child) bear the economic loss. Ideally, such loss will (1) reduce the parent's taxable estate, (2) avoid gift tax liability in a situation where the child ends up with nothing, and (3) entitle the parent to income tax deductions for the losses of the venture. If the venture succeeds, it is important that most or all of the value created end up in the hands of the child, while avoiding potential gift taxes and estate taxes to the maximum possible extent. Accordingly, choosing the right structure for the funding is important.

All wealth-shifting strategies, other than GRATs, have potential adverse consequences associated with their use. OPGRATs can avoid the disadvantages inherent in the alternative funding techniques, while shifting almost all the upside appreciation to the child. Because the strategy is intended to help fund the child's venture or as a training mechanism, it will be assumed that the parent's role will be either negligible or non-existent. Before discussing the OPGRAT, it may be helpful to review the disadvantages of alternative funding techniques.

Disadvantages of alternative funding techniques

Gifts. Annual exclusion gifts, currently limited to $12,000 per donee, per calendar year, and gifts that do not incur a current gift tax, limited to $1 million over the life of the donor, could provide funds to the child. These amounts can be doubled for married taxpayers, with spousal consent.

In the uncertain tax world where potential estate tax repeal must be considered, in the absence of special circumstances (probably not present in a situation where success is speculative), the amount targeted for transfer should be limited by the amount that can be given with no current gift tax. Consequently, a disadvantage arises from the limits on the amount that can be given with no current gift tax.

Each dollar of annual exclusion gift represents an opportunity to augment the wealth of the donee at no transfer tax cost. Thus, the imposition of limits on tax-free gifts means that transfers within the limits are properly viewed as using a scarce and valuable resource, which might be used more effectively elsewhere. As a result, transfers that use up the annual exclusion (unless the client would not otherwise make annual exclusion gifts) or the lifetime credit against gift taxes should ordinarily be made only when the value transferred will be preserved for the benefit of the child. Choosing to make an annual exclusion gift of funds that will intentionally be placed at risk means choosing to possibly waste the annual exclusion.

It is incorrect to believe that the unproductive use of annual exclusion gifts and the $1 million exempt amount comes without cost. Certainly, use of the $1 million exempt amount adversely affects future gifts, as well as adding estate taxes at the transferor's subsequent death. Use of annual exclusion gifts for risky ventures might preclude their use elsewhere, which could hinder the client's other wealth-shifting endeavors.

For example, a popular wealth-shifting strategy that would be adversely affected is the installment sale of an asset having a high likelihood of growing in value to an income tax defective grantor trust, which is typically structured in ways that leverage annual exclusion and/or credit shelter gifts. In such sales, we believe it is prudent to follow the rule of thumb that 10% "seed" money be contributed to the trust, in order to give the transaction economic substance. Use of annual exclusion gifts in a less advantageous manner (such as funding the child's venture) eclipses the ability to use these annual exempt gift amounts as "seed" money for an installment sale. If the donor is choosing between a sale that will maximize the likelihood of wealth-building in the hands of the donee through annual exclusion gifts and a gift to finance a risky venture, each dollar of annual exclusion gift used to finance the venture will have a multiplier effect in dramatically reducing the amount the parent can sell to the trust within the theoretical 10% presumed safety net.

In general, it would be better to make gifts of assets that are likely to be preserved rather than assets that are at a heightened risk of loss.

Loans. If the parent makes a loan to the child, the argument goes, that loan can be made at the relatively cheap applicable federal rate ("AFR") required under Section 7872. The hoped-for advantage of such a loan is that a taxable gift is avoided, while the child uses the

funds to create new value that far outpaces the interest charged on the loan. The effect is that the parent intentionally suffers underperformance so that the child can pursue super performance. Unfortunately, this vision of the future is flawed in that it does not contemplate underperformance or failure of the venture pursued by the child.

Section 7872 governs the tax treatment of certain interest-free and low interest (i.e., below-market) loans, imputing interest based on the difference between the AFR and the rate actually charged. That difference will be treated as income to the lender and as a gift by the lender to the borrower. Because a detailed analysis of the imputed interest rules on below-market loans is beyond the scope of this article, we will assume that a loan would be made at the lowest amount allowable to fall within the safe harbor protection of Section 7872.

A parent's loan made to seed the child's venture will typically be structured as an interest-only loan, with all principal due at the end of the term of the loan. Assuming the interest is paid, the parent must pay income tax on that interest. It may well be that the parent is in the top income tax brackets, while the child may not be paying income taxes at all. If the loan proceeds are used to create an investment portfolio, investment interest limitations may limit or deny the child a current deduction for interest.[1] Thus, the parent's income tax cost might not be offset by tax savings of the child from deducting that interest. On the other hand, if interest is not paid, the parent may have to pay gift taxes on that unpaid interest.

A further tax disaster looms if the principal is not repaid in full. A parent who makes a loan to a child may be reluctant or unwilling to pursue collection. If a loan from the parent to the child is not repaid, the failure to enforce the obligation within the applicable statute of limitations will usually constitute a gift at the time the loan becomes unenforceable.[2] If, at the inception of the "loan," there was no intention that the loan would be repaid, the gift would be immediate.[3] The absence of repayment risks IRS scrutiny about the intention of the parties at the outset of the loan.

Uncertainty about whether a family has made unintended taxable gifts casts a cloud over planning for transactions involving intended gifts because the amount of past gifts is not precisely known.

From the child's perspective, gifts, including forgiveness of indebtedness, do not constitute taxable income.[4]

However, if the debt is not the subject of a gift, the parent may be able to claim a bad-debt deduction for the loss.[5] In all likelihood, the debt will be a non-business bad debt, with the result that the deduction will be a long-term capital loss.[6] Even then, to be deductible, the entire amount owing must be shown to be worthless; there is no deduction for a partially worthless debt.[7] The child, on the other hand, may have income from forgiveness of indebtedness, unless the child is insolvent and can qualify for the protection of Section 108.

IRS scrutiny of intra-family loans can be expected, since the intent of family members can be difficult to discern without a fairly intensive discovery of facts. The specter of IRS intervention can, in and of itself, make larger family loans unattractive.

A failed GRAT, on the other hand, is not a loan. In a GRAT, the grantor transfers property and retains an interest in the property in the form of a fixed annuity. Because the trust is nearly always a grantor trust, the grantor is treated as owning the property held in trust. The Tax Code does not recognize a loan to one's self. Because the GRAT annuity payments cannot be characterized as a loan, the income tax consequences associated with loans will apply to neither the parent nor the child.

Loan guarantees. If a parent guarantees a loan to a child and subsequently has to make good on the guarantee, that course of action will be treated as a gift to the child.

It is also possible that the IRS may argue that the gratuitous guarantee will itself give rise to annual taxable gifts to the child or to a trust (if that vehicle is used). Accordingly, it would be prudent for the parent to receive a reasonable guarantee fee for the use of the parent's credit. Professors Casner and Pennell summarize these principles as follows:

> With respect to a guarantee, if Parent is never called upon to make good on the guarantee—which would generate significant gift or discharge of indebtedness income considerations—giving the guarantee alone should be treated only as a gift of the value of the guarantee—presumably what Child would pay an independent third party to obtain the guarantee, which could be quite expensive.[8]

Investment in newly formed entity. A parent wishing to help a child start a business might be tempted

[1] See Section 163(d)(3).
[2] Estate of Lang, 613 F.2d 770, 45 AFTR2d 80-1756 (CA-9, 1980).
[3] Miller, TCM 1996-3 ; Hunt, TCM 1989-335.
[4] See Section 102.
[5] See Section 166.
[6] Section 166(d).
[7] Reg. 1.166-5(a)(2).

to form a new corporation, partnership or limited liability company, and then invest in it or loan money to it. If the venture is successful, the ownership interest that is part of the parent's estate will grow in value. Attempts to limit or freeze the upside value by having the parent invest in a preferred interest are likely to run afoul of Section 2701, which is designed to subject valuation freezes to gift taxes.

Reg. 25.2701-1(b)(2)(i)(A) provides that a contribution to capital of a newly formed corporation or partnership is treated as a transfer. If that transfer is assigned a zero value because it is an "applicable retained interest," the entire up-front investment will be treated as a gift.

GRAT basics

GRATs are statutorily sanctioned by Section 2702 and thus, are a relatively safe strategy. In a GRAT, the grantor transfers property to an irrevocable trust, retaining the right to receive annuity payments for a fixed term of years. At the end of the fixed term, whatever remains in the trust after payment of the annuity interest either passes to the remainder beneficiaries, or remains in further trust for their benefit, free of any additional gift tax.

As a result of the *Walton*[9] decision and the ensuing amendment of Reg. 25.2702-3(e), Example 5, the value of the remainder interest—which is the taxable gift—can be zeroed out, although we suggest that a small gift be made. To the extent that the property appreciates at a rate in excess of the Section 7520 rate, that property will pass to the remainder beneficiary(ies) gift-tax-free at the end of the trust term.

The annuity interest must be payable at least annually and may be designed to increase by 20% per annum,[10] which is the usual course of action for most GRATs.

The OPGRAT

Assume a child approaches his parent needing $1 million to acquire or start a business venture. The parent, recognizing the risks associated with start-up ventures, is still willing to fund the undertaking, and is happy to "shift" the fruits of a potentially successful venture to the child, while the parent bears the downside risk of a failed venture.

Although the parent has many options—gifts, loans, loan guarantees, and an investment in the venture—the parent could consider creating a nearly zeroed-out GRAT for the benefit of the child. The term of the GRAT should match the purpose of the funding. In the case of an entrepreneurial venture, the business plan should give some indication as to how long it will take to determine if the business will either prosper or fail. The term should be selected so that the vast bulk of the annuity payments can be paid out of profits and the design of the annuity should generally take advantage of the permissible 20% per annum increase so that early payments from cash flow will be more affordable.

On one hand, the upside value-shifting potential of a GRAT may be quite dramatic because all the appreciation in excess of the return specified in the IRS tables passes tax-free to the remainder beneficiary (indeed, possibly the quintessential leveraging device). On the other hand, the downside cost of a "failed GRAT," after *Walton*, is minimal—i.e., the negligible gift, plus transaction costs. Furthermore, based on the above analysis, other forms of funding used in conjunction with an economically failed venture would be more counterproductive.

It is fundamental to the success of the OPGRAT strategy that annuity payments be made in assets that are not subject to a valuation discount, normally cash. Therefore, in addition to the funds needed to acquire and run the venture, cash should also be placed into the GRAT sufficient to fund the GRAT annuity payments (during the embryonic period) to the extent the venture cannot.[11] Generally, we will know in the first couple of years whether the venture will succeed. If it will not, the parent will have received in the form of annuity payments at least a partial recovery of "seed" money and the GRAT will fail. But if the venture is successful, then the earnings of the entity will support the later annuity payments.

Because the GRAT is a grantor trust, the grantor will be paying the income tax on the trust earnings. This makes payment of the annuity easier because the GRAT's cash flow unreduced by income tax will be available to pay the annuity. In addition, the grantor may claim loss deductions for income tax purposes, if the venture fails.

The risks

The OPGRAT is neither a panacea nor the recommended strategy for all clients who wish to help or train their children financially; however, we believe it is a viable option that should be considered in many situations.

Mortality. A major risk to an otherwise successful GRAT is that the grantor might not survive the annuity term. In that case, the IRS takes the position that the property belonging to the GRAT, including the appreciation, is includable

[8] Casner and Pennell, *Estate Planning*, § 6.3.3.6 (1999).

[9] 115 TC 589 (2000), *acq.*, Notice 2003-72, 2003-2 CB 964.

[10] Reg. 25.2702-3(b)(1)(ii)(A).

in the grantor's estate under Section 2039. Most practitioners believe that the correct estate tax exposure is determined under Section 2036(a) and is limited to the amount in the GRAT that is necessary to produce the annuity owed to the grantor.[12]

If the IRS is correct and if the venture is successful, the exposure to estate tax could be substantial. If the IRS is incorrect and the venture is successful, the result is a substantial wealth shift free from gift or estate taxes. Furthermore, if the venture is unsuccessful, the maximum exposure will be the value of the unsuccessful venture and not a waste of annual exclusion or gifting ability, or the inefficient use of the gift tax exemption.

The risk of inclusion on account of death can be hedged by the acquisition of life insurance on the grantor's life. The amount of estate tax exposure of a successful venture (and therefore, the amount of insurance protection) is subject to conjecture and incapable of an accurate estimation, but can be extremely high if the investment of the GRAT achieves significant success (i.e., think Google or Microsoft).

One method of capping the growth exposure is by having the remainder beneficiary of the GRAT, or a trust for his benefit, acquire an option to purchase the assets that are owned by the GRAT. A lower cost alternative might be possible if such an option were structured to be exercisable only if the grantor dies during the trust term. For estate tax valuation purposes, Section 2703(a) disregards options that do not meet the requirements of Section 2703(b). Consequently, any option purchased from the GRAT should be structured to comply with the requirements of Section 2703(b). Generally, the option must be "a bona fide business arrangement"; it must not be "a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth"; and its terms must be "comparable to similar arrangements entered into by persons in an arms' length transaction."

If the grantor is uninsurable or highly rated, that factor alone should signal the advisor to suggest an alternative strategy, one that does not have a mortality risk. Indeed, the OPGRAT strategy is generally not recommended for older or infirm grantors. Because the typical profile of the child is that of a younger person starting a new venture or a younger person's training device, the typical person who is fronting the money generally will be younger, such as a parent in his 50's or 60's helping a child in his 20's or 30's.

GST limitations. The OPGRAT is also not advisable as a grandparent/grandchild planning device, because the property shifted to the grandchild at the end of the term would be exposed to the generation-skipping transfer ("GST") tax at the full value at the termination of the grantor's interest. Section 2642(f) precludes the allocation of GST exemption until the end of the retained annuity period, the so-called "ETIP" (i.e., estate tax inclusion period) rule. At that time, the transfer would be subject to GST tax, and the leverage inherent in the GRAT technique is not obtainable with respect to the GST tax.

Income taxes

During the annuity period. During the term of the GRAT, the grantor will be taxed on the income of the trust because of its grantor trust status.[13] That result is generally desirable in GRAT planning, because the taxes paid by the grantor will reduce his estate, and the property—together with earnings—that are ultimately shifted to the child will be unreduced by the income tax.

Taxes paid by the parent are not considered a taxable gift.[14] Taxes paid on assets passing to the child are functionally equivalent to a tax-free gift. Payment of income tax by the grantor also enables the GRAT to more easily fund the annuity payments back to the grantor because all cash flow (unreduced by income tax attributable to the earnings) will be available to be distributed in satisfaction of the annuity that must be paid. Moreover, if the venture fails, the grantor should be able to deduct the losses for income tax purposes.

Reimbursement of grantor's income taxes. If the grantor, for some reason (e.g., the grantor was willing to lend money but wanted it back if success was achieved) did not want to pay the tax on the trust income, the grantor could authorize the trustee to reimburse him on account of the tax on the income earned by the trust. A clause authorizing reimbursement should generally be placed in the GRAT document regardless of the intention of the parties at the time of funding, as a hedge against a runaway investment, which would subject the grantor to excessive tax exposure beyond what is affordable or acceptable to the grantor. The discretionary reimbursement

[11] If there is a shortfall in cash to pay the annuity, the requirement that the annuity must be paid will result in a partial in-kind distribution, subject to a valuation discount. In such instance, the grantor should consider re-GRATing the in-kind property under circumstances where success is still anticipated.

[12] See Rev. Rul. 76-273, 1976-2 CB 268.

[13] See Section 671 through Section 678, which generally provide that a trust grantor who retains certain rights enumerated in these Code sections will, for income tax purposes, be treated as the owner of property held in the trust. Thus, the income, gains, losses, deductions, and credits of property held in such a trust are attributed to the grantor.

power should not cause estate tax inclusion[15] in the grantor's estate if the power is held by an independent trustee.

If the grantor had a reimbursement power and did not exercise it, there would be a gift by the grantor to the GRAT with two disastrous consequences. First, the grantor would be making a gift subject to gift tax. Second, the prohibition against an additional contribution to the GRAT would be violated, disqualifying the GRAT.[16] To protect against an inadvertent gift to the GRAT, which would cause disqualification, the drafter might place a provision in the document specifying that any attempted contribution which would otherwise be deemed an addition to the GRAT, will automatically be held as a separate GRAT under the terms of the instrument.

Often, when GRATs are set up, the grantor will be the trustee during the term, with a co-trustee or special trustee authorized to exercise the reimbursement power. An exception is where the property contributed to the GRAT is stock of a "controlled corporation," to avoid estate tax inclusion for an extended term under Section 2036(b), if the grantor is trustee.[17]

Under the OPGRAT structure, the remainder beneficiary—and not the grantor—will typically be the trustee. For example, if the OPGRAT is used in lieu of a loan for the child to go into business, or for the child to begin managing investments, the parties will generally select the child to be in full control. In such instance, an independent or special trustee—and not the remainder beneficiary—should have the reimbursement power in order to preclude the IRS's arguing that a transfer back to the grantor is a gift from the beneficiary to the grantor. Although such an argument should not prevail because the exercise of the power was in a fiduciary capacity and should be no more than the exercise of a special power of appointment, we have seen more bizarre arguments prevail over the last several years in the estate planning world.[18]

Even though there might be minimal exposure to the transfer tax system for a beneficiary/trustee having the reimbursement power, practically speaking, the grantor should control the identity of the independent trustee who can reimburse him. For example, if the GRAT assets explode in value, but the parent-child relationship deteriorates,

[14] See Rev. Rul. 2004-64, 2004-27 IRB 7.
[15] *Id.*
[16] Reg. 25.2702-3(b)(5).

EXHIBIT 1
Comparison Chart

	Portion of Economic Benefit Passing to Child if Venture Successful	Transfer Tax Burden if Venture Successful	Portion of Economic Loss Borne by Parent if Venture Fails	Ability of Parent to Obtain Income Tax Deduction if Venture Fails
OPGRAT	Very high	Virtually zero	All	Full deduction
Gift of $1 Million	Very high	Fully subject to gift/estate taxes	None—child bears entire loss	No deduction
Loan of $1 Million to Child or Trust for Child	Very high	Low	None—and if child defaults, parent might be treated as making taxable gift	Limited to capital loss for non-business bad debt, if it qualifies
Loan Guarantee of $1 Million Loans	Very high	Very low	None—and if child defaults, parent treated as making taxable gift	Inconsistent with being treated as having made taxable gift
Equity Investment of $1 Million by Parent	Low	Very high—future growth subject to gift/estate taxes	All	Full deduction
Loan of $1 Million to Child's Business Entity	Very high	Low	All, if loan is unsecured	Capital loss for non-business bad debt, if it qualifies

the grantor would not have been well-advised to have entrusted the reimbursement power to a person the child controls.

After the term. In most cases in GRAT planning, we advise that the property passing at the termination of the trust continue to be held in a defective grantor trust because the consequences are, in effect, a tax-free addition to the trust by the grantor in the amount of annual income taxes and a commensurate reduction in the grantor's estate. In such instance, the grantor would be able to release the powers that cause the trust to be income tax defective if he no longer wished to pay tax on the income. The OPGRAT can offer the same planning ability and should be considered.

A comparison chart illustrating the features of an OPGRAT and those of alternative strategies appears in Exhibit 1.

Practical design considerations to maintain the understanding of the parties

The advisor should keep in mind that the understanding of the parties using the OPGRAT is that success, if it occurs, will inure to the child. Thus, if success is reasonably expected to be achieved, an alternative funding vehicle—such as a gift to a beneficiary-controlled dynastic defective trust, a loan, or loan guarantee—is probably the recommended course of action. The OPGRAT is typically viewed as a downside protective measure where significant performance risk is present.

Often, a married grantor will hedge the survivorship feature by qualifying the property belonging to the GRAT for the estate tax marital deduction to the extent it is includable in his estate. That course of action is contrary to the understanding of the parties, creates planning difficulties, and could expose the other family members to some problems. For example, if the grantor (Dad) dies during the term of the OPGRAT, and the OPGRAT's interest passes to Mom, or to a trust for Mom, this could result in significant unhappiness.

Life insurance. Life insurance can be acquired as a hedge against premature death. The amount of coverage relative to an exploding asset is unpredictable. It is also a cost that a parent may not wish to bear. The issue is more acute if there are other children to be considered and the parent wishes to achieve the general parental goal of treating each child equally.

Perhaps the child should acquire the life insurance, paying for it through compensation from the venture. In such instances, the grantor might qualify the asset for the marital deduction and have the child use the proceeds of the life insurance to buy the asset from the estate.

Conclusion

Estate planning advisors must attune themselves to the unique needs and risks of helping clients help their offspring. A properly drafted OPGRAT provides a means to place seed money or an educational investment portfolio under the management of a child and reward success through ownership of upside gains. At the same time, the OPGRAT can minimize adverse transfer tax and income tax risks associated with loss of principal that may arise when such funding is accomplished through outright gifts, intra-family loans, loan guarantees, or direct participation investments. ■

[17] Perhaps a more adventuresome advisor, with a control-seeking client, might have the client be trustee until three years prior to the expiration of the GRAT.

[18] One has to look only at the recent decisions in *Estate of Strangi*, 115 TC 478 (2000), *aff'd in part, rev'd in part sub nom.* Gulig, 293 F.3d 279, 89 AFTR2d 2002-2977 (CA-5, 2002), *on remand*, TCM 2003-145, *aff'd* 417 F.3d 468, 96 AFTR2d 2005-5230 (CA-5, 2005), relating to the application of Section 2036(a)(2), and *Chawla v. Transamerica Occidental Life Insurance Co.*, 2005 WL 405405 (ED Va., 2/3/05), dealing with insurable interests of life insurance trusts, to conclude that virtually anything is possible. Hopefully, these cases only illustrate that bad facts make bad law.