

The GRAT Remainder Sale

It's the latest in sophisticated estate planning. But significant advance planning is critical to making it work to a client's advantage.

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Estate planners who handle high-net-worth clients are constantly looking for new techniques to leverage their clients' gift and generation-skipping transfer tax exemptions. In 2000, the U.S. Tax Court held in *Walton v. Commissioner*¹ that Treasury Reg. Section 25.2702-3(e), Example 5 is an invalid interpretation of Internal Revenue Code Section 2702. That decision enhanced the effectiveness of the Grantor Retained Annuity Trust (GRAT) remainder sale strategy as a means of moving assets into multi-generational trusts without a gift tax or generation-skipping transfer tax.

In this article, we explain the GRAT technique and the incredible leveraging opportunities available in light of *Walton*. We also examine the GRAT's generation-skipping limitations, and how they can be circumvented by having the GRAT remainderman sell the "remainder equivalent" (that is to say, an amount equal to the fair market value of the remainder interest) to a generation-skipping transfer (GST) tax-exempt dynasty trust. We then demonstrate with examples why significant advance planning is necessary. That planning is based primarily on

whether the IRC Section 7520 rate (the Applicable Federal Rate, or AFR) is expected to move up, down, or stay the same from the date the GRAT is funded to the day the remainder interest is sold.

GRAT Defined

A GRAT² is an irrevocable trust into which the settlor makes a gift of property and retains an annuity payable for a term of years, or for the shorter of a term of years or the settlor's death. If the settlor survives the term, any property remaining in the trust passes without any additional gift tax to the remaindermen, or to trusts for their benefit.

settlor has enough remaining applicable exclusion, no gift tax will be due. Generally, if the assets transferred to the GRAT appreciate or produce income at a rate higher than the AFR, the transaction will successfully leverage the gift tax exemption.

Walton

Before *Walton*, it was common for the settlor to retain a reversionary interest in a GRAT. The GRAT would provide that if the settlor fails to survive the GRAT term, the GRAT will terminate and the GRAT property would be distributed to the settlor's estate, where

Even if the strategy fails to work, there is no monetary loss.

For gift tax purposes, the value of the gift upon creation of a GRAT is determined by subtracting the value of the retained interest from the value of the property gifted to the GRAT. The retained interest is valued using the AFR promulgated by Treasury pursuant to IRC Section 7520 for the month in which the gift is made. If the

it would pass under his will or revocable trust.

There are two primary reasons for such a structure. First, if the settlor fails to survive the GRAT term, the entire trust property may be included in his gross estate under IRC Sections 2036 and/or 2039. Thus, by retaining a reversionary interest and causing the GRAT

THE AFR DROPS

What happens to the remainder value when the AFR rate decreases from the time the GRAT is funded to the date when the remainder interest is sold.

Days into Year 1	Annuity Factor	AFR	Remainder Value
0	5.5824	4%	\$21.58
1	5.6205	5.8	(68,226.47)
2	5.6187	5.8	(65,002.06)
3	5.6169	5.8	(61,777.65)
4	5.6151	5.8	(58,553.23)
5	5.6133	5.8	(55,328.82)
6	5.6115	5.8	(52,104.41)
7	5.6097	5.8	(48,880.00)
8	5.6079	5.8	(45,655.59)
9	5.6061	5.8	(42,431.17)
10	5.6043	5.8	(39,206.76)
11	5.6025	5.8	(35,982.35)
12	5.6007	5.8	(32,757.94)
13	5.5989	5.8	(29,533.53)
14	5.5971	5.8	(26,309.11)
15	5.5953	5.8	(23,084.70)
16	5.5935	5.8	(19,860.29)
17	5.5917	5.8	(16,635.88)
18	5.5899	5.8	(13,411.47)
19	5.5881	5.8	(10,187.05)
20	5.5863	5.8	(6,962.64)
21	5.5845	5.8	(3,738.23)
22	5.5827	5.8	(513.82)
23	5.5809	5.8	2,710.59
24	5.5791	5.8	5,935.01
25	5.5773	5.8	9,159.42
26	5.5755	5.8	12,383.83
27	5.5737	5.8	15,608.24
28	5.5719	5.8	18,832.65
29	5.5701	5.8	22,057.07
30	5.5683	5.8	25,281.48
31	5.5665	5.8	28,505.89
32	5.5647	5.8	31,730.30
33	5.5629	5.8	34,954.71
34	5.5611	5.8	38,179.13
35	5.5593	5.8	41,403.54
36	5.5575	5.8	44,627.95
37	5.5557	5.8	47,852.36
38	5.5539	5.8	51,076.77
39	5.5521	5.8	54,301.19
40	5.5503	5.8	57,525.60
41	5.5485	5.8	60,750.01
42	5.5467	5.8	63,974.42
43	5.5449	5.8	67,198.83
44	5.5430	5.8	70,423.24
45	5.5412	5.8	73,647.65

property to pass under the settlor's will or revocable trust, it may be possible to defer or eliminate estate tax through the use of marital and charitable deductions.

Second, the Internal Revenue Service has taken the position in Treasury Reg. Section 25.2702-3(e), Example 5 that if a GRAT is structured so that the settlor retains the right to an annuity for a fixed term regardless of whether he is living (that is to say, he does not retain a reversion entitling his estate to the GRAT property if he does not survive the term), the right of the settlor's estate to the remaining annuity payments is not a qualified interest for purposes of IRC Section 2702 and thus is valued at zero.⁴ In other words, the annuity interest in a GRAT always would be valued as if it were payable for the shorter of the GRAT term and the life of the settlor. The effect of such position is that the value of the annuity interest retained by the settlor is always reduced by the value of the possibility that the settlor will not survive for the entire term (that is to say, the value of the contingent interest of the settlor's estate), thereby increasing the value of the remainder transferred.

However, in *Walton*, the Tax Court held that Example 5 is an invalid interpretation of IRC Section 2702. The court reasoned that the entire annuity interest was retained by the taxpayer, because no transfer could be deemed to have been made to the taxpayer's estate. The court also found that a fixed term annuity, payable to the settlor or the settlor's estate, is within IRC Section 2702's permissible parameters of a qualified interest, as elucidated by legislative history. Accordingly, the court concluded that, because Congress intended to allow individuals to retain qualified interests for a specified term of years and the

proper method for doing so is to make the balance of any payments due after the settlor's death payable to the settlor's estate. Example 5 was an unreasonable interpretation and invalid extension of IRC Section 2702.⁵

Unlike a GRAT payable for the "shorter of" a term and the settlor's life, a fixed-term GRAT (a *Walton* GRAT) can be structured so that no taxable gift is made upon its creation. That is, the GRAT can be structured so that the present value of the annuity interest exactly equals the value of the property transferred to the GRAT, leaving the remainder with a value of zero. The taxable gift in a "shorter of" GRAT cannot be eliminated because the value of the retained reversion is always deemed to be transferred to the remaindermen. Thus, a *Walton* GRAT is a no-lose estate planning device: if the strategy fails due to the settlor's death or poor investment results, there is no loss because neither gift tax has been paid nor applicable credit used.

Generation-Skipping Problem

Under IRC Section 2642(f)(1), the settlor cannot allocate GST exemption to property transferred during the estate tax inclusion period (ETIP). The ETIP is the period of time after the transfer during which the value of the property transferred would be includible in the transferor's gross estate (other than by reason of IRC Section 2035, which brings certain transfers within three years of death back into the taxable estate).⁶ Because a GRAT is a transfer that is includible in the settlor's estate if the settlor dies prior to the end of the GRAT term, the transfer is subject to the ETIP rules and GST exemption may not be allocated until the end of the term. Allocating GST

THE AFR HOLDS STEADY

What happens to the remainder value when the AFR rate remains the same from the time the GRAT is funded to the date when the remainder interest is sold.

Days into Year 1	Annuity Factor	AFR	Remainder Value
0	5.5824	6%	\$23.58
1	5.5806	6	3,248.00
2	5.5788	6	6,472.41
3	5.5771	6	9,517.69
4	5.5753	6	12,742.10
5	5.5735	6	15,966.51
6	5.5718	6	19,011.79
7	5.5700	6	22,236.20
8	5.5682	6	25,460.61
9	5.5664	6	28,685.02
10	5.5647	6	31,730.30
11	5.5629	6	34,954.71
12	5.5611	6	38,179.13
13	5.5594	6	41,224.40
14	5.5576	6	44,448.82
15	5.5558	6	47,673.23
16	5.5540	6	50,897.64
17	5.5523	6	53,942.92
18	5.5505	6	57,167.33
19	5.5487	6	60,391.74
20	5.5469	6	63,616.15
21	5.5452	6	66,661.43
22	5.5434	6	69,885.84
23	5.5416	6	73,110.26
24	5.5398	6	76,334.67
25	5.5381	6	79,379.95
26	5.5363	6	82,604.36
27	5.5345	6	85,828.77
28	5.5327	6	89,053.18
29	5.5309	6	92,277.59
30	5.5292	6	95,322.87
31	5.5274	6	98,547.28
32	5.5256	6	101,771.70
33	5.5238	6	104,996.11
34	5.5221	6	108,041.39
35	5.5203	6	111,265.80
36	5.5185	6	114,490.21
37	5.5167	6	117,714.62
38	5.5149	6	120,939.03
39	5.5132	6	123,984.31
40	5.5114	6	127,208.72
41	5.5096	6	130,433.14
42	5.5078	6	133,657.55
43	5.5060	6	136,881.96
44	5.5042	6	140,106.37
45	5.5025	6	143,151.65

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exemption at the end of the term when the trust property has already appreciated in value fails to leverage the exemption.

However, it is possible to shift the benefits of a GRAT before the GRAT terminates to a GST exempt trust that continues for multiple generations. Specifically, the remaindermen of the GRAT can sell their remainder interest to a GST exempt dynasty trust, thereby effectively shifting the benefits of the GRAT to a GST exempt trust from which distributions can be made to successive generations free of additional transfer taxes. In order to avoid a gift by the GRAT remaindermen to the dynasty trust, the purchase price paid by the dynasty trust should be the fair market value of the remainder, as determined under IRC Section 7520.

PLR 200107015

In Private Letter Ruling 200107015,⁷ the IRS was asked to consider the federal gift and generation-skipping transfer tax consequences of the assignment of a vested remainder interest by a beneficiary of a testamentary charitable lead annuity trust (CLAT). The taxpayer requested the IRS to rule that upon termination of the CLAT and distribution of trust assets to the child's children pursuant to the assignment, there would not be a transfer subject to GST tax because the child rather than the decedent would be treated as the transferor of the assets.

Instead, the IRS held that the proposed transactions would have the effect of circumventing the generation-skipping rules and that, therefore, there would be two transferors for GST purposes. The child would be treated as the transferor of an amount equal to the present value of the remainder interest on the date of the child's transfer, and the decedent would continue to be treated as the

transferor of the balance of the value of the CLAT. The ruling also indicated that under these facts the IRS might disregard the form of the transaction and view the transaction as though the trustees designated the child's children as the vested remainder beneficiaries. If the IRS collapsed the transaction in this manner, the decedent would continue to be treated as the transferor of the entire trust for GST purposes. If the decedent is treated as the transferor to the grandchildren, a taxable termination would occur upon termination and distribution of the CLAT.

The "Remainder Equivalent"

Most estate planners believe that the holding in PLR 200107015 is wrong. However, since many of the issues involving the transfer of a GRAT remainder interest are similar to those involving the transfer of a CLAT remainder interest, the prudent planner should consider using an alternative structure in designing a transaction that is nearly identical in result, but without the same risk.

Specifically, the remaindermen of the GRAT should contractually agree to pay the dynasty trust the value of any amount the remaindermen receive 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 clause 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

market conditions are such that the assets in the GRAT change value prior to the sale and either cause the value of the remainder interest

between the date the GRAT is funded and the date the remainder interest is sold to the GST exempt dynasty trust. The reason is that

The transaction potentially works best when the AFR drops between the date the GRAT is funded and the date the remainder interest is sold.

contractual investment with the remaindermen, with the hope that it turns into something valuable.

"Remainder Equivalent" Sale

Setting up the sale transaction is much like a game of chess. The estate planner must plan ahead for the possibility of the sale, and also plan for the approximate date of the sale, as well as knowing the approximate value of the remainder interest on such planned date.

Some pointers:

- Establish the GST exempt dynasty trust as far in advance of setting up the GRAT as possible, and plan to have as much time as possible between the date the GRAT is funded and the date the remainder interest (or remainder equivalent) is sold. This will reduce the possibility that the IRS could successfully recast the series of transfers as a step transaction.

- Plan ahead as to whether the sale will be made later in the same month as the month in which the GRAT is funded, or in the following month. For an extremely large asset, assuming no change in value of the asset between the two dates, the transaction will only work well if the AFR moves down between the date the GRAT is funded and the date the remainder equivalent is sold.

- When funding the GRAT, try to use an asset that will not change in value between the date the GRAT is funded and the date the remainder interest is sold.

- Be willing to accept defeat if

to be negative or to be too high for the transaction to work. If so, make sure the client understands that the GRAT itself (that is to say, without the sale) is a great transaction. If the right types of assets are used to fund the GRAT, this "problem" should be relatively rare.

Examples

The transaction potentially works best when the AFR moves down

the change in time value is offset by the change in the AFR, as those two variables are opposite in their effect on the value of the remainder interest. Consequently, the planner may consider waiting until about the twentieth day of the calendar month when the next month's AFR is announced in order to determine the direction of the next month's AFR.

For example, assume that a

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THE AFR RISES

What happens to the remainder value when the AFR rate increases from the time the GRAT is funded to the date when the remainder interest is sold.

Days into Year 1	Annuity Factor	AFR	Remainder Value
0	5.5824	6%	\$23.58
1	5.5412	6.2	73,826.79
2	5.5394	6.2	77,051.20
3	5.5377	6.2	80,096.48
4	5.5359	6.2	83,320.89
5	5.5342	6.2	86,366.17
6	5.5324	6.2	89,590.58
7	5.5307	6.2	92,635.86
8	5.5289	6.2	95,860.27
9	5.5272	6.2	98,905.55
10	5.5255	6.2	101,950.83
11	5.5237	6.2	105,175.24
12	5.5220	6.2	108,220.52
13	5.5202	6.2	111,444.93
14	5.5185	6.2	114,490.21
15	5.5167	6.2	117,714.62
16	5.5150	6.2	120,759.90
17	5.5132	6.2	123,984.31
18	5.5115	6.2	127,029.59
19	5.5097	6.2	130,254.00
20	5.5080	6.2	133,299.28
21	5.5062	6.2	136,523.69
22	5.5045	6.2	139,568.97
23	5.5027	6.2	142,793.38
24	5.5010	6.2	145,838.66
25	5.4992	6.2	149,063.07
26	5.4975	6.2	52,108.35
27	5.4957	6.2	155,332.76
28	5.4940	6.2	158,378.04
29	5.4922	6.2	161,602.45
30	5.4904	6.2	164,826.86
31	5.4887	6.2	167,872.14
32	5.4869	6.2	171,096.55
33	5.4852	6.2	174,141.83
34	5.4834	6.2	177,366.24
35	5.4817	6.2	180,411.52
36	5.4799	6.2	183,635.93
37	5.4782	6.2	186,681.21
38	5.4764	6.2	189,905.62
39	5.4747	6.2	192,950.90
40	5.4729	6.2	196,175.31
41	5.4711	6.2	199,399.73
42	5.4694	6.2	202,445.00
43	5.4676	6.2	205,669.42
44	5.4659	6.2	208,714.69
45	5.4641	6.2	211,939.11

client transfers an asset worth \$10 million to a 7-year *Walton* GRAT, with the remainder payable to a grantor trust for the primary benefit of the client's child. Assume further that the AFR is 6 percent and the retained annuity is a fixed 17.9134 percent per annum so that the taxable gift to the GRAT is \$23.58. The taxable gift is computed by multiplying the term certain annuity factor by the annual annuity amount, and then subtracting this figure from the principal transferred to the GRAT as follows: \$10 million minus (5.5824 x \$1,791,340) = \$23.58. The appropriate annuity factor can generally be found in IRS Publication 1457. However, factors that are not based on a full calendar year (such as that which is used to compute the value of a remainder interest some time after the date the GRAT is funded) must be computed by hand.

Assuming that the value of the assets owned by the GRAT remains the same between the date the GRAT is funded and the date the remainder equivalent is sold, and that the AFR decreases from 6 percent to 5.8 percent, the optimum date for the sale is 23 days after the GRAT is funded.⁸ The value of the remainder interest on that date is \$2,710.59. (See "The AFR Drops," page 34.)

Planners need to be careful to select a GRAT term that is short enough to create a low positive value for the remainder interest on the date of the anticipated sale. If, for example, there is an AFR of 6 percent and a GRAT term of seven years, the transaction works well. Had the term been 10 years instead of seven, though, the remainder interest would have been negative until two calendar months after the GRAT is funded (assuming the value of the asset transferred to the GRAT does not increase during that time).

Assume the same facts as in the example above. What if the AFR stays the same between the date the GRAT is funded and the date the remainder equivalent is sold? Answer: the sale price of the remainder equivalent increases each day. (See "The AFR Holds Steady," page 35.)

What if, with the same facts, the AFR rises from 6 percent to 6.2 percent during the critical period? Then, unless the value of the assets owned by the GRAT decreases, the value of the remainder equivalent increases drastically as soon as the AFR increases. Therefore, planners should avoid using this technique if the AFR will be increasing. (See "The AFR Rises," page 38.)

Attractive Device

The Walton case made GRATs much more attractive planning

devices. They can now be used to transfer excess return (that is to say, return on investment in excess of the AFR) without making a taxable gift. The more property transferred to the GRAT and the greater the excess return, the more property that will be transferred to the remaindermen free of gift tax. By using the techniques we've described, those benefits can be shifted to a GST exempt trust, thereby allowing multiple generations to benefit from the original GRAT, as well as the compounding growth of the transferred assets for years to come. ♦

Endnotes

1. *Walton v. Comm'r*, 115 TC No. 41 (2000).
2. For a more detailed explanation of how the GRAT technique leverages the gift tax exemption, please see David A. Handler and Steven J. Oshins, "GRAT

Remainder Sale to a Dynasty Trust," *Trusts & Estates* (Dec. 1999).

3. For example, the Nov. 2002 Section 7520 rate was 3.6 percent. Thus, if the GRAT property grows at a rate greater than 3.6 percent, the strategy will have successfully transferred property to the remaindermen free of gift tax.
4. See, also Ltr. Rul. 9253031 (Jan. 1, 1993).
5. See Deborah V. Dunn, "Coming to a Wal-Mart Near You: Tax-Free GRATs," *Trusts & Estates*, April 2001; Richard A. Oshins, "The Walton GRAT—A 21st Century Planning Tool," *CCH-Estate Planning Review*, Vol. 27, No. 7 (July 19, 2001); and Jerome J. Caulfield, "The Quest for the Zeroed-Out GRAT: Walton Says It Can Be Done," *28 Estate Planning Magazine* 251 (June 2001).
6. IRC Sec. 2642(f)(3).
7. See Jonathan E. Gopman, Todd I. Steinberg and Steven J. Oshins, "Ruling on Assignment of Vested Remainder Interest May Have Reached Wrong Conclusion," Tax Management Memorandum (Sept. 2001).
8. The optimum date is the one that will produce the lowest sales price that is not a negative value.



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