

## **GRANTOR RETAINED ANNUITY TRUSTS**

A grantor retained annuity trust (“GRAT”) is one of several investment driven estate planning techniques that try take advantage of the applicable Section 7520 rate.<sup>1</sup> If the assets in the GRAT appreciate at more than the 7520 rate, and the grantor survives until the end of the trust term, the trust beneficiaries receive all that extra appreciation tax-free at the end of the GRAT. A GRAT is a trust in which the grantor retains the right to receive a fixed annuity for a term of years. At the end of the term, the remaining trust principal and income not used to pay the annuity is transferred to the remainder beneficiaries under the trust, and is no longer part of the grantor’s taxable estate upon his or her death.

### **GIFT TAX**

The transfer of property to a GRAT may or may not be subject to gift tax. The gift to the trust’s remainder beneficiaries is calculated upon the creation of the GRAT. The gift is equal to the value of the property transferred to the GRAT less the present value of the retained annuity interest by the grantor. (see Valuation below).

If the ultimate beneficiaries of the GRAT are members of the grantor’s family, the present value of the retained annuity is determined under IRC Section 2702. A “qualified interest” retained under that section is valued using the tables published by the IRS under IRC Section 7520. A retained interest that does not meet the “qualified interest” requirements (see the following Section) is valued at zero and the current value of the entire interest transferred to the GRAT is treated as a gift.

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<sup>1</sup> The Section 7520 rate is the rate published monthly by the IRS, pursuant to IRC Section 7520, that is used to determine the value of any annuity or interest for a term of years. The rate is equal to 120% of the Federal midterm rate in effect at the time of publication under IRC Section 1274(d)(1).

## QUALIFIED INTEREST

In order for a GRAT to qualify for the Section 7520 rate gift tax calculation mentioned above, the annuity retained by the grantor must be a qualified interest. The grantor must retain an irrevocable right to receive a fixed amount at least annually. Treas. Reg. 25.2702-3(b)(1)(i). The amount may be a specific dollar amount or a fixed fraction or percentage of the initial fair market value of the property transferred to the trust. Treas. Reg. 25-2702-3(b)(1)(ii). It is preferable to express the amount as a fixed percentage of the property in the trust. If it later determined by the IRS that the valuation was incorrect, the amount of the annuity would be changed to reflect the new valuation and would still be deemed a “fixed amount” because the amount of the annuity will not have changed, it would only be updated to reflect the new valuation. However, the Regulations allow for the amount of the annuity payment to increase over the term of the GRAT, but not in excess of 120 percent of the amount paid in the previous year. Treas. Reg. 25-2702-3(b)(1)(ii). Increasing the annuity payment every year causes a lower initial annuity payment, but much larger payments toward the end of the GRAT term compared to a steady annuity payment. This annuity variation can be useful if the trust principal is not producing enough income to make the annuity payment in the beginning of the GRAT term, but is expected to produce significantly more income in the future, which could cover the larger future payments.

The annuity can be paid based on the taxable year of the GRAT or the GRAT’s anniversary date. Additionally, the annuity can be paid monthly, quarterly, or semiannually. If the annuity is payable on the anniversary date of the GRAT’s creation, the payment must be paid within 105 days after the anniversary date. Treas. Reg. 25-2702-3(b)(4). If the annuity is based on the taxable year, the annuity payment must be paid on or before the date by which the trusts Federal income tax return is due for that year, irregardless of any extensions granted. Treas. Reg. 25-2702-3(b)(4). If the GRAT principal is expected to grow during the applicable grace periods above, the annuity payment should be made as late as possible to take advantage of the additional increase in value of the assets in the GRAT.

The annuity payment must be in money or money's worth. The trust instrument must prohibit the use of notes, other debt instruments, or similar financial arrangements to satisfy the annuity payment. Treas. Reg. 25-2702-3(d)(6). The trust instrument must prohibit additional contributions to the trust by any person, including the grantor. Treas. Reg. 25-2702-3(b)(5). The trust document must also prohibit distributions from the trust to any person or for the benefit of any person other than the grantor during the term of the annuity. Treas. Reg. 25-2702-3(d)(3)

The trust document must specify a fixed term for the annuity. Treas. Reg. 25-2702-3(d)(4). The annuity term must be for the life of the grantor, for a specific number of years, or for the shorter of those two periods. Treas. Reg. 25-2702-3(d)(4). The trust instrument must also prohibit commutation, i.e., prepayment, of the annuity. Treas. Reg. 25-2702-3(d)(5).

## **REVERSIONARY INTERESTS**

In the past, some GRATs were created with a reversionary interest to the grantor. If the grantor did not survive the GRAT term, these GRATs were designed to terminate and cause the reversion of the remaining trust property back to the grantor's estate. The grantor would create a will or a trust prior to his death that would then pass this reversion to beneficiaries according to that respective document. If the grantor was married, the will or trust would typically be designed to defer estate taxes through the use of the marital deduction.

*Walton v. Commissioner*, 115 T.C. No. 41 (2000), changed the benefits of retaining a reversionary interest. Before *Walton*, the IRS took the position that if a GRAT were structured so that the grantor's estate was to receive the remaining annuity payments after the grantor's death, the remaining annuity payments would not constitute a qualified interest under Section 2702. The effect of this position was that the annuity was always valued as lasting until the earlier of the GRAT term or the death of the

grantor. This would decrease the value of the annuity by the possibility that the grantor would fail to survive the GRAT term, and thus increase the value of the gift.

However, in *Walton*, the court held that the IRS's position was not a proper interpretation of Section 2702. The Court looked to the legislative history of Section 2702 and stated that Congress intended to allow grantors to retain qualified annuity interests for a set term of years. The simplest method of doing so was for the trust to require that the remaining annuity payments be made to the grantor's estate after the grantor's death. The IRS has acquiesced in this holding in *Walton*, and therefore, it is now possible for a grantor to structure a GRAT which results in no gift tax liability (a "zeroed-out GRAT").

## **ESTATE TAX**

If the grantor does not survive the term of the GRAT, some or all of the property remaining in the GRAT will be includible in the grantor's gross estate. The amount of trust property includible in the grantor's estate if the grantor died prior to the end of the GRAT term was unsettled prior to new Treasury Regulations that became effective on July 11, 2008. Prior to these new regulations, in Rev. Rul. 82-105, the IRS had ruled that the portion of trust property needed to produce enough income to satisfy the remaining annuity payments at the then prevailing 7520 rate, was included under Section 2036. However, this ruling conflicted with a previous ruling (*See*, Rev. Rul. 76-273), and also did not consider whether Section 2033 or 2039 would cause additional trust assets to be included in the grantor's gross estate. Later, the IRS took the position that all of the remaining property in a GRAT is includible in the grantor's estate under Section 2039 if the grantor dies during the GRAT's term. TAM 200210009.

The adoption of Treas. Reg. 20.2036-1(c)(2) and Treas. Reg. 20.2039-1(e)(1) changed all this. Section 2039 no longer applies to GRATs. *See*, Treas. Regs. 20.2036-1(c)(2)(iii), Example 2 and 20.2039-1(e)(1). The IRS's position in Rev. Rul. 82-105 regarding the amount of trust property includible in the grantor's estate under IRC Section 2036 was incorporated into Treas. Reg. 20.2036-1(c)(2). That portion of the

remaining trust property needed to produce enough income to satisfy the remaining annuity payments is included in the grantor's gross estate<sup>2</sup>. This amount is calculated by dividing the annual annuity payment by the prevailing 7520 rate at the time of the grantor's death. *Id.*

In Treas. Reg. 20.2036-1(c)(2)(iii), Example 2, the grantor transfers \$100,000 to a GRAT retaining a qualified annuity interest in the amount of \$12,000 per year, payable monthly, for a term of ten years or until the grantor's earlier death. The grantor dies prior to the expiration of the ten year term. On the grantor's date of death, the value of the trust assets is \$300,000 and the 7520 rate was 6%. The annual annuity of \$12,000 is adjusted \$12,326.40 to reflect that the payments are made monthly. That amount is then divided by the 7520 rate at that time, 6%. That amount, \$205,440, is includible in the grantor's gross estate under Section 2036(a)(1), which is less than the \$300,000 in the trust at that time.

However, it is possible that under the Section 2036 calculation the full amount of the remaining principal would still be included in the grantor's gross estate. This is more likely to occur if the 7520 rate decreased during the term of the GRAT or if the assets did not perform well during that time.

## **INCOME TAX**

A GRAT is normally structured to be a grantor trust, if the grantor can afford to pay the income tax liability generated by the trust. By creating a GRAT as a grantor trust, the grantor will receive the benefit of utilizing the 7520 rate and be able to more quickly reduce his or her gross estate by paying the income tax without the payment of the tax being treated as a gift itself. A GRAT can qualify as a grantor trust under IRC 677 by

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<sup>2</sup> The language of the Treas. Reg. 20.2036-1(c)(2) describes the includible amount as "that portion of the trust corpus necessary to provide the decedent's retained use or retained annuity, unitrust, or other payment (without reducing or invading principal)." This plain language automatically caps the amount includible in the grantor's gross estate at the value of the assets currently in the trust.

providing that the annuity be paid first from income, and then to the extent necessary, from principal. Priv. Letter Rul. 9504021 (Jan. 27, 1995).

## VALUATION

A GRAT is valued differently depending on whether the grantor retains a reversionary interest. If the grantor retains a reversionary interest, the remainder that is ultimately distributed to the beneficiaries of the GRAT is calculated and subtracted from the value of the property transferred to the GRAT. The reversionary interest is not a qualified interest, and is therefore valued at zero. This makes the value of the retained annuity larger because less is subtracted from the present value of the property transferred. The value of the retained annuity is lower due to the fact that the grantor may not receive the full amount of the annuity if the grantor dies prior to the end of the GRAT term.

If the grantor does not retain a reversionary interest, i.e., the grantor's estate retains the right to receive the annuity upon the grantor's death, the taxable gift is determined by subtracting the value of the right to receive an annuity for a specified number of years from the value of the property transferred to the GRAT.

The calculation of the annuity itself is based on the length of the annuity's term, the total amount of the annuity, the current 7520 rate, and in some instances, the age of the grantor. The present value of the retained annuity will be higher, and thus the taxable gift lower, with higher annuity payments, a lower 7520 rate, and/or a younger grantor. The 7520 rate is the rate of return that the IRS assumes the GRAT will produce. As previously mentioned a GRAT is beneficial if the property transferred to the GRAT is expected to appreciate at more than the current 7520 rate. If a GRAT does not appreciate at a rate higher than the 7520 rate, the GRAT will be exhausted before the term is finished and nothing will have been removed from the grantor's estate. Accordingly, GRATs are more beneficial estate planning tools when the 7520 rate is lower because it

is easier to outperform a lower rate, and thus, more likely that a greater amount of property will be removed from the grantor's estate.

Since the *Walton* decision, it is now possible to zero-out a GRAT. A zeroed-out GRAT is set up so that the present value of the retained annuity payments by the grantor over a fixed term is equal to the current value of the assets transferred to the trust. This creates a remainder of zero and no gift tax liability. If the property appreciates at more than the 7520 rate, there will be property left in the GRAT to pass to the beneficiaries tax free.

Consider the following examples.

George transfers \$1,000,000 to a GRAT. The GRAT will pay an annuity in the amount of \$116,038 a year for ten (10) years. The 7520 rate in July 2009 is 2.8%. If the GRAT actually appreciates at the rate of 2.8% per year, nothing will remain at the end of the GRAT to pass to the beneficiaries.

Year	Start of Year	Growth	Annuity	End of Year
1	\$1,000,000	\$28,000	(\$116,038)	\$911,962
2	\$911,962	\$25,535	(\$116,038)	\$821,459
3	\$821,459	\$23,001	(\$116,038)	\$728,422
4	\$728,422	\$20,396	(\$116,038)	\$632,780
5	\$632,780	\$17,718	(\$116,038)	\$534,460
6	\$534,460	\$14,965	(\$116,038)	\$433,387
7	\$433,387	\$12,135	(\$116,038)	\$329,484
8	\$329,484	\$9,226	(\$116,038)	\$222,672
9	\$222,672	\$6,235	(\$116,038)	\$112,869
10	\$112,869	\$3,160	(\$116,038)	\$(0)

If, however, the GRAT actually appreciated at 5.0% per year over the GRAT's term, \$169,381 would be passed to the remainder beneficiaries at the end of the GRAT term tax free.

Year	Start of Year	Growth	Annuity	End of Year
1	\$1,000,000	\$50,000	(\$116,038)	\$933,962
2	\$933,962	\$46,698	(\$116,038)	\$864,622
3	\$864,622	\$43,231	(\$116,038)	\$791,815
4	\$791,815	\$39,591	(\$116,038)	\$715,368

5	\$715,368	\$35,768	(\$116,038)	\$635,098
6	\$635,098	\$31,755	(\$116,038)	\$550,815
7	\$550,815	\$27,541	(\$116,038)	\$462,318
8	\$462,318	\$23,116	(\$116,038)	\$369,396
9	\$369,396	\$18,470	(\$116,038)	\$271,828
10	\$271,828	\$13,591	(\$116,038)	\$169,381

As previously mentioned, the IRS allows the GRAT to increase the annual annuity payment by up to 120% per year. Assume the GRAT appreciates at a rate equal to the 7520 rate of 2.8%. This gives the assets time to appreciate if the GRAT can not produce the amount of income in the first few years to pay the annuity amount in a level payout GRAT, such as the first example.

Year	Start of Year	Growth	Annuity	End of Year
1	\$1,000,000	\$28,000	(\$46,516)	\$981,484
2	\$981,484	\$27,482	(\$55,819)	\$953,147
3	\$953,147	\$26,688	(\$66,983)	\$912,852
4	\$912,852	\$25,560	(\$80,380)	\$858,032
5	\$858,032	\$24,025	(\$96,456)	\$785,601
6	\$785,601	\$21,997	(\$115,747)	\$691,851
7	\$691,851	\$19,372	(\$138,896)	\$572,327
8	\$572,327	\$16,025	(\$166,675)	\$421,677
9	\$421,677	\$11,807	(\$200,010)	\$233,474
10	\$233,474	\$6,537	(\$240,012)	\$(0)

If the GRAT assets consistently appreciate faster than the 7520 rate, the GRAT will have a larger remainder to pass to the intended beneficiaries because the assets will remain in the GRAT longer, and thus have a longer time to appreciate. If they do not consistently appreciate, the increasing GRAT may not be as beneficial. Assume a growth rate of 5% per year and an annuity increasing at 120% per year. At the end of the graduated payout term with consistently appreciating assets, the remainder is \$213,926 as opposed to \$169,381 in the level payout GRAT with the same growth rate above. This is \$44,545 more that is passed tax-free to the beneficiaries and removed from the grantor's estate.

Year	Start of Year	Growth	Annuity	End of Year
1	\$1,000,000	\$50,000	(\$46,516)	\$1,003,484
2	\$1,003,484	\$50,174	(\$55,819)	\$997,839
3	\$997,839	\$49,892	(\$66,983)	\$980,748
4	\$980,748	\$49,037	(\$80,380)	\$949,405
5	\$949,405	\$47,470	(\$96,456)	\$900,419
6	\$900,419	\$45,021	(\$115,747)	\$829,693
7	\$829,693	\$41,485	(\$138,896)	\$732,282
8	\$732,282	\$36,614	(\$166,675)	\$602,221
9	\$602,221	\$30,111	(\$200,010)	\$432,322
10	\$432,322	\$21,616	(\$240,012)	\$213,926

### **ROLLING GRATs**

However, in reality not all assets continually appreciate at a steady rate. To take advantage in the fluctuation in the annual return rate each year, the rolling GRAT technique was developed. Rolling GRATs are a series of successive short-term GRATs funded with the annuity payments from previous GRATs. One of the major advantages of this technique is the reduced risk that the grantor will die during the GRAT and thereby cause all or a portion of the GRAT property to be included in the grantor's estate. If the grantor dies during a successive GRAT, all of the benefits gained from the previous GRATs will not be lost.

The other major advantage of a rolling GRAT is that it is superior to a single longer term GRAT if the assets are volatile in nature. One year of poor returns can make it very difficult for a longer term GRAT to ultimately create any benefit because of the increased performance needed in the remaining years of the GRAT term. The rolling GRATs "lock-in" the remainder during each two-year term, if any, and remove that amount of extra appreciation out of the grantor's estate before possibly losing it during a future year with poor performance.

There are two main drawbacks to this technique: frequent valuations and changes in the 7520 rate. The property would need to be valued at the time it is transferred to each

successive GRAT. If the property is publicly traded stock, for example, this would not be an issue as the value would be readily available. However, if the grantor funds the GRAT with closely held stock, the grantor would have to hire a professional appraiser to value the property each time a successive trust is created. This could be costly. Additionally, no one can predict with certainty what the 7520 rate will be in the future. With a long term GRAT, the grantor locks in the 7520 rate for the term of the GRAT. The 7520 rate may increase significantly in a few years making the “hurdle rate” for the assets going into the “rollover GRATs” higher. However, this risk is minimized by the lower investment risk during a poor year.

Assume the following annual rates of return on the assets in a 10-year GRAT: 2, -3, 8, -5, 7, 4, 10, 6, 4, 5. The average rate of return is 3.8%. A 10 year fixed term GRAT would exhaust its assets before the end of the GRAT term.

Year	Start of Year	Growth	Annuity	End of Year
1	\$1,000,000	\$20,000	(\$116,038)	\$903,962
2	\$903,962	\$(27,119)	(\$116,038)	\$760,805
3	\$760,805	\$60,864	(\$116,038)	\$705,631
4	\$705,631	\$(35,282)	(\$116,038)	\$554,311
5	\$554,311	\$38,802	(\$116,038)	\$477,075
6	\$477,075	\$19,083	(\$116,038)	\$380,120
7	\$380,120	\$38,012	(\$116,038)	\$302,094
8	\$302,094	\$18,126	(\$116,038)	\$204,182
9	\$204,182	\$8,167	(\$116,038)	\$96,311
10	\$96,311	\$4,816	(\$101,127)	\$(0)

Now, let us assume the same rates of return per year with rolling GRATs and further assume a constant 7520 rate during the 10 years of the rolling GRATs. The same \$1,000,000 is initially contributed to a 2-year zeroed-out GRAT (GRAT 1). At the end of year 1, the \$521,105 annuity payment from GRAT 1 is used to fund another two-year zeroed-out GRAT, GRAT 2. At the end of the next year, the \$483,928 annuity payment from GRAT 1 and the \$271,550 annuity payment from GRAT 2 are used to fund another two-year zeroed-out GRAT, GRAT 3. This continues for the 10 years.

## GRAT 1 (yr 1 and 2)

Year	Start of Year	Growth	Annuity	End of Year
1	\$1,000,000	\$20,000	(\$521,105)	\$498,895
2	\$498,895	\$(14,967)	(\$483,928)	\$(0)

## GRAT 2 (yr 2 and 3)

Year	Start of Year	Growth	Annuity	End of Year
1	\$521,105	\$(15,633)	(\$271,550)	\$233,922
2	\$233,922	\$18,714	(\$252,636)	\$(0)

## GRAT 3 (yr 3 and 4)

Year	Start of Year	Growth	Annuity	End of Year
1	\$755,478	\$60,438	(\$393,683)	\$422,233
2	\$422,233	\$(21,112)	(\$393,683)	\$7,438

## GRAT 4 (yr 4 and 5)

Year	Start of Year	Growth	Annuity	End of Year
1	\$646,319	\$(32,316)	(\$321,167)	\$292,836
2	\$292,836	\$20,499	(\$313,335)	\$(0)

## GRAT 5 (yr 5 and 6)

Year	Start of Year	Growth	Annuity	End of Year
1	\$714,850	\$50,040	(\$372,512)	\$392,378
2	\$392,378	\$15,695	(\$372,512)	\$35,561

## GRAT 6 (yr 6 and 7)

Year	Start of Year	Growth	Annuity	End of Year
1	\$685,847	\$27,434	(\$357,398)	\$355,883
2	\$355,883	\$35,588	(\$357,398)	\$34,073

## GRAT 7 (yr 7 and 8)

Year	Start of Year	Growth	Annuity	End of Year
1	\$729,910	\$72,991	(\$380,360)	\$422,541
2	\$422,541	\$25,352	(\$380,360)	\$67,533

GRAT 8 (yr 8 and 9)

Year	Start of Year	Growth	Annuity	End of Year
1	\$737,758	\$44,265	(\$384,449)	\$397,574
2	\$397,574	\$15,903	(\$384,449)	\$29,028

GRAT 9 (yr 9 and 10)

Year	Start of Year	Growth	Annuity	End of Year
1	\$764,809	\$30,592	(\$398,546)	\$396,855
2	\$396,855	\$19,843	(\$398,546)	\$18,152.

Nothing was passed to the remainder beneficiaries in the previous example utilizing the single ten-year GRAT. But the rolling GRAT produced a far superior result under the exact same circumstances. The rolling GRAT passed \$191,785 to the remainder beneficiaries.