TAXATION

GRAT Remainder Sale To A Dynasty Trust

THE GRAT IS ONE OF THE more sophisticated estate planning techniques used to leverage the gift tax exemption. Notwithstanding the benefits of the GRAT technique, one of its negative features is that the ETIP rules preclude effective allocation of generation-skipping transfer tax exemption to the GRAT until the end of the trust term, thereby negating its generation-skipping effectiveness.

This article introduces a method of creating the functional equivalent of a generation-skipping GRAT by having the GRAT remaindermen sell the remainder interest to a GST exempt dynasty trust in order to circumvent the ETIP problem.

As each new high of the stock market indices is reached and each Internet startup company goes public, thousands of people are suddenly finding themselves worth tens or hundreds of millions — in some cases billions — of dollars. Mere use of the applicable exclusion and annual exclusion gifts is inadequate to transfer significant portions of such enormous wealth to descendants in a tax-efficient manner. Thus, there is an increased focus on more sophisticated leveraging techniques. One such technique is the Grantor Retained Annuity Trust ("GRAT"). A GRAT is an irrevocable trust into which the settlor makes a gift of property and retains an annuity payable for a term of years. 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.

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 "Applicable Federal Rate" ("AFR") promulgated by the Treasury pursuant to IRC Sec. 7520 for the month in which the gift is made. If the 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.[1]

For purposes of valuing a gift to a GRAT, IRC Sec. 2702 provides that if a person transfers an interest in trust to or for the benefit of a member of his or her family and the transferor or an "applicable family member" retains an interest in the trust, then for purposes of determining the value of the interest transferred, any retained interests in the trust that are not "qualified interests" are valued at zero. An "applicable family member" includes the transferor's spouse, an ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor.[2] Both the annuity for a fixed term of years retained by the settlor and the remainder transferred to the remaindermen are qualified interests. However, the reversion retained by the settlor is not a qualified interest, and therefore its value is treated as zero. Because the value of the gift upon creation of a GRAT is determined by subtracting the value of the qualified interests retained by the settlor, the value of the reversion is effectively reflected in the remainder value transferred to the remaindermen. In effect, the value of the reversion is subject to gift tax as if it had been transferred to the remaindermen, although it was actually retained by the settlor. Thus, the gift to the remaindermen is the present value of the amount actuarially expected to remain in the GRAT at the end of the term, plus the value of the reversion.

Notwithstanding the benefits of the GRAT technique, there are two negative features. First, if the settlor dies prior to the end of the GRAT term, some or all of the trust assets are included in the settlor's estate.[3] The settlor typically retains a reversionary interest in the GRAT so that the

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property will pass as part of his or her estate if he or she does not survive the GRAT term. Second, as explained below, the settlor cannot allocate generation-skipping transfer ("GST") tax exemption to the trust until the end of the GRAT term, thus precluding use of the GRAT to leverage the GST tax exemption. This article addresses this second problem and offers a solution that estate planners should consider.

The Generation-Skipping Problem and Solution

Under IRC Sec. 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 Sec. 2035, which brings certain transfers within three years of death back into the taxable estate).[4] Since 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 exemption at the end of the term B when the trust property has already appreciated in value B fails to leverage the exemption.

However, it is possible to shift the benefits of a GRAT B before the GRAT terminates B 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 Sec. 7520. As stated above, if a person (the children) transfers an interest in trust to or for the benefit of a member of his or her family (the dynasty trust), and an applicable family member retains an interest in the trust (the annuity retained by the settlor), the value of "non-qualified interests" (the reversion) are valued at zero. Thus, because the value of the remainder is determined by subtracting the value of the qualified annuity interest retained by the settlor from the value of the property transferred to the GRAT, the value of the reversion is reflected in the value of the remainder. As a result, the price paid by the dynasty trust must include the value of the reversion.

CHART 1

Year	Start of Year	10% Growth	Annuity	End of Year
1	$1,000,000	$100,000	$(138,450)	961,550
2	$961,550	$96,155	$(138,450)	919,255
3	$919,255	$91,926	$(138,450)	872,731
4	$872,731	$87,273	$(138,450)	821,554
5	$821,554	$82,155	$(138,450)	765,259
6	$765,259	$76,526	$(138,450)	703,335
7	$703,335	$70,333	$(138,450)	635,218
8	$635,218	$63,522	$(138,450)	560,290
9	$560,290	$56,029	$(138,450)	477,869
10	$477,869	$47,787	$(138,450)	$387,206

Example

In Chart 1, Client, who is 55, establishes a $1 million, 10-year GRAT, with the remainder payable to Client's children. Assuming an AFR of 6.4 percent and the GRAT is "economically zeroed-out,"[5] the retained annuity is $138,450 per annum and the taxable gift from the GRAT is $43,900. The GRAT remainder is payable to a trust for the benefit of Client's children.

The trustee of the trust for the benefit of Client's children sells its remainder interest in the GRAT to a GST exempt dynasty trust previously created by Client. Assuming the sale occurs shortly after the GRAT is funded and the GRAT property has not changed in value, the purchase price is $43,900. Upon termination of the GRAT at the end of 10 years, assuming the trust appreciates at a rate of 10 percent per year, $387,000 will remain in the GRAT and pass to the GST exempt dynasty trust free of additional gift and estate tax.

This represents a 24 percent annual return on the dynasty trust's $43,900 investment. Because the dynasty trust is GST exempt, distributions may be made to grandchildren and more remote descendants free of gift, estate and generation-skipping taxes.

Alternatively, the GRAT could be funded with limited partnership interests with a discounted value of $1 million (after applying a combined minority and marketability discount of 33 percent), and the annuity payments made using the cash flow generated by the limited partnership interests. In this case, upon termination of the GRAT at the end of 10 years, assuming the trust appreciates at a rate of 10 percent per year, $1.68

million will remain in the GRAT and pass to the GST exempt dynasty trust free of additional gift and estate tax. Thus, the dynasty trust will have realized a 44 percent annual return on its $43,900 investment.

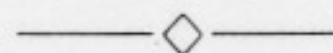
Structuring the Sale

If the GRAT remainder is payable to the settlor's descendants on a *per stirpital* basis, the settlor's children will only have the right to sell their *contingent* remainder interest. Thus, to ensure all parties in interest are parties to the sale to the GST exempt trust, the takers in default of the children (i.e., the grandchildren and more remote descendants) would need to participate in the sale. Guardians ad litem may be required to represent the interests of minor and unborn beneficiaries, all adding to the complexity of the transaction. Another option is to make the GRAT remainder payable to the settlor's children or their respective estates. This structure would provide the children with a *vested* remainder interest capable of being sold without the involvement of their descendants.

However, a preferable alternative is to make the remainder payable to a trust for the benefit of the children (a "remainder trust"). The remainder trust could be one already established by the client, or a new one that is nominally funded (e.g., with $100). The trustee of the remainder trust would own a vested remainder in the GRAT that it would be able to sell to the GST exempt trust.

The remainder trust alternative is preferable to a vested remainder in the children because it can also eliminate recognition of capital gain by the children upon their sale of the GRAT remainder to the GST exempt trust. Depending on the children's basis in the GRAT remainder and the timing of its sale, the gain recognition could otherwise be significant. However, if the remainder trust and GST exempt trust are both "grantor trusts" as to the settlor of the GRAT, the sale of the remainder will be a non-event for income tax purposes, treated as a sale by the settlor to himself or herself.[6] Grantor trust status could be achieved, for example, by giving the settlor, in a nonfiduciary capacity, the power to substitute property of an equivalent value[7] or by including the settlor's spouse as a beneficiary.[8] Thus, through the use of grantor trusts, the remainder sale transaction is simplified and capital gain recognition is avoided.

The settlor may not effectively allocate GST tax exemption to a GRAT until the end of the trust term because of the ETIP rules.



In addition, it is best to have established the dynasty trust far in advance of the remainder sale to reduce the chance that the Service could successfully argue substance over form and recast the series of transfers as a generation-skipping GRAT.

Finally, one must make sure the "spendthrift clause" in the GRAT does not prohibit the sale of the remainder interest by the remaindermen. Although this will make the GRAT remainder susceptible to the reach of the remaindermen's creditors, this risk is also mitigated by making the GRAT remainder payable to a trust, in which case only the creditors of the remainder trust (not the creditors of the beneficiaries thereof) will be able to reach the remainder. There are likely to be far fewer potential business and tort creditors with respect to the remainder trust than with respect to the beneficiaries.

GST Pitfalls

Even though the GRAT remainder is sold to a GST exempt trust, it is possible, under a strict reading of the Code, that a taxable termination under IRC Sec. 2612(a) could occur upon the distribution of the GRAT remainder to the GST exempt trust at the end of the GRAT term. Under IRC Sec. 2611(a), a generation-skipping transfer can either be a taxable distribution, a taxable termination or a direct skip. A "taxable termination" is a termination of an interest in property held in trust unless immediately after the termination a non-skip person has an interest in the property or no distribution may ever be made to a skip person.[9]

IRC Sec. 2613 defines a "skip person" as a person two or more generations below the generation of the transferor, or a trust of which all of the beneficiaries are skip persons. IRC Sec. 2652(a) defines "transferor" as the donor in the case of property subject to gift tax. A transfer is subject to gift tax for purposes of Chapter 13 if gift tax is imposed *(without* regard to any credits, exclusions, or deductions).[10] The initial transfer of property upon the creation of a GRAT is a transfer subject to gift tax. Thus, the settlor is a "transferor" for purposes of Chapter 13, and his or her grandchildren, being two generations below the settlor, are skip persons.

Moreover, if all of the beneficiaries of the GST exempt trust are grandchildren (or more remote descendants) of the settlor, the GST exempt trust technically is also a skip person with respect to the settlor. As a result, a taxable termination may occur upon the termination of the GRAT because the settlor's interest in the property terminates and the property is distributed to a skip person (the GST exempt trust) from a trust with an inclusion ratio of one (the GRAT). Under a strict reading of the Code, this result is not changed by the fact that the GRAT remainder is purchased by a GST exempt trust because that trust falls within the definition of a skip person when all of the beneficiaries are skip persons.

However, if any non-skip person (e.g., a child of the settlor of the GRAT) is a beneficiary of the GST exempt trust at the time the GRAT terminates, the GST exempt trust will not be a skip person when the

GRAT remainder is distributed to it; thus, no taxable termination occurs. When the child subsequently dies and the GST exempt trust becomes a skip person with respect to the settlor, no GST tax will be due because the trust is GST exempt.

Although many practitioners would conclude that it is unlikely that the Service would find a taxable termination at the end of the GRAT term if the remainder is sold to a GST exempt trust with no non-skip persons as beneficiaries, the conservative approach is to avoid the issue. Thus, the GST exempt trust that will purchase the GRAT remainder should always include at least one non-skip person as a beneficiary. For example, it could be a "pot" trust as to all of the settlor's descendants (including children). The more non-skip persons that are included as beneficiaries, the lower the risk they will all die before the GRAT terminates. The trustee could also be given the power to add beneficiaries, in which case the trustee could add a non-skip person as a trust beneficiary (perhaps on a limited basis or for a limited time, e.g., until the GRAT terminates) in the event all of the non-skip persons originally included as beneficiaries die.

Another technique to avoid this issue would be to have the settlor purchase the remainder from the GST exempt trust just before the end of the GRAT term (i.e., just before the potential taxable issue would arise). Presumably, the value of the remainder would be significally greater than it was on the date the GRAT was initially funded. Economically, this would have little or no adverse effect since the remainder would be sold to the settlor for its fair market value. The sale would be disregarded for income tax purposes since the trust is a grantor trust.[11]

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Conclusion

With estates growing so rapidly, there is an increased emphasis on advanced techniques to leverage the gift and GST tax exemptions. One technique that is commonly used to leverage the gift tax exemption is the GRAT. However, the settlor may not effectively allocate GST tax exemption to a GRAT until the end of the trust term because of the ETIP rules. This article suggests a technique to avoid the ETIP problem and, in effect, create the equivalent of a generation-skipping GRAT. ◆

ENDNOTES

1. For example, the June 1999 Sec. 7520 rate was 6.4 percent. Thus, if the GRAT property grows at a rate greater than 6.4 percent, the strategy will have successfully transferred property to the remaindermen free of gift tax.
2. IRC Sec. 2701(e)(2).
3. IRC Secs. 2036, 2039. See also Rev. Rul. 76-273, 1976-2 C.B. 268.
4. IRC Sec. 2642(f)(3).
5. See Handler, "Economically Zeroed-Out GRATs Produce the Best Results," Trusts & Estates, January 1999.
6. Rev. Rul. 85-13, 1985-1 C.B. 184.
7. IRC Sec. 675(4)(c).
8. IRC Sec. 677(a)(1).
9. IRC Sec. 2612(a).
10. Treas. Reg. Sec. 26.2652-1(a)(2).
11. See Endnote 6