ESTATE PLANNING BENEFITS WITH LAYERED GRATS

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Transfers of Interests in Trust and the Special Valuation Rules

Internal Revenue Code section 2702 (hereinafter IRC), enacted in 1990 as part of chapter 14 of the IRC,[1] is a gift tax provision that deals with transfers of interests in trust to or for the benefit of members of the transferor's family. Internal Revenue Code section 2702 applies to transfers after October 8, 1990.

Prior Law

Internal Revenue Code section 2702 replaced the ten-year GRIT (grantor-retained income trust) with the GRAT (grantor-retained annuity trust) and the GRUT (grantor-retained unitrust). The ten-year GRIT was advantageous in that the Internal Revenue Service (IRS) tables were used to value the income interest, regardless of the actual income yield, resulting in an undervaluation of the gift. The IRC section 2702 GRATs and GRUTs are not limited to ten years. This adds greater flexibility. In addition, there was always the risk with a GRIT that the IRS would question the investment of the trust assets in low-yielding assets, and the beneficial gift tax treatment could be disqualified on that ground. Since the GRAT and the GRUT are valued based on the annuity or unitrust amount, there is no risk of disqualification.

General Valuation Rule Under Prior Law

For purposes of estate or gift tax, assets are valued at their fair market value on the date of the transfer. This is generally the price that a willing buyer would pay to a willing seller in an arm's-length transaction, where both parties have knowledge of all relevant factors.

For a transfer of a partial interest (such as an interest for a term of years) in property for which no fair market value can be obtained, the U.S. Treasury has developed special valuation rules based on certain assumed interest rates and the length of the term interest. These rules have been codified in IRC section 7520, which is keyed to the mid-term applicable federal rate, a rate that changes monthly. While this valuation method may be effective in most instances, it can result in a windfall for the taxpayer.

For example, if an individual creates a trust, retaining an income interest for a period of years and funds it with low-dividend/high-growth stock, the IRC section 7520 rate will usually exceed the actual yield on the property. This will result in an overvaluation of the income interest and an undervaluation of the transferred remainder interest. The bottom line is a smaller gift and, consequently, a lower gift tax.

IRC § 2702 Valuation Rules

Internal Revenue Code section 2702 prescribes special valuation rules for certain transfers of property in trust and joint purchases, which eliminate the valuation benefits described above. Generally, where there is a transfer of an interest in trust to or for the benefit of a member of the transferor's family, and the transferor or an applicable family member retains an interest in the property, which is not a "qualified interest," the retained interest is valued at zero.

"Family member" is defined to include the transferor's spouse, any ancestor or lineal descendant of the transferor or the transferor's spouse, any brother or sister of the transferor and the spouse of any of the foregoing individuals. Although the definition is broad, it does not include nieces, nephews and cousins, and all non-family members, including a live-in companion. The common law GRIT, and applicable valuation rules, is still available for these individuals.

The regulations provide that the following transfers are excepted from the special valuation rules:

1. a charitable remainder trust;
2. a charitable lead trust;
3. a pooled income fund;
4. a personal residence trust (special rules apply to personal residence trusts,[2] which are beyond the scope of this discussion);
5. a spousal property settlement under IRC section 2516; and
6. incomplete gifts.

It is important to note that for IRC section 2702 to apply, an interest must be retained by the transferor or an applicable family member. The regulation clarifies that "retained" means held by the same individual both before and after the transfer.[3] If, for example, a husband creates a trust with an income interest in his wife and a remainder interest in his children, the special valuation rules do not apply because there is no retained interest. Both the income and remainder interests are created.

Qualified Interest—GRATs and GRUTs

In order to avoid valuing a retained interest at zero, it must be a "qualified interest." A qualified interest comes in three forms:

1. the right to receive a fixed amount payable at least annually (a grantor-retained annuity interest or GRAT);
2. the right to receive a fixed percentage of property at least annually, based on its annual fair market value (a grantor retained unitrust or GRUT); and
3. a non-contingent remainder, if all the other trust interests are in the form of 1 or 2 above.

A qualified interest is valued under IRC section 7520 and subtracted from the value of the transferred property. Because the valuation of the retained interest is based on the actual annuity or unitrust payment, the value of the transferred interest will more accurately reflect actual value than it would have under prior law. A retained income interest under a GRIT would not be a qualified interest and would be valued at zero.

Special Valuation Examples

The following examples, taken from the regulations, illustrate the application of the special valuation rules to certain fact patterns:

Example 1: Mary transfers property to a trust, retaining the right to the income for a period of ten years. On the expiration of the ten-year term, the trust corpus is paid to Mary's child. If Mary dies during the ten-year term, the trust corpus is paid to her estate.

Since neither of Mary's interests is a qualified interest, they are both valued at zero. Therefore, the amount of the gift is the fair market value of the property transferred to the trust.

Example 2: John transfers property to a trust retaining a ten-year annuity interest (GRAT) that meets the statutory requirements. Upon the expiration of the ten-year term, the trust corpus is paid to John's child. The amount of the gift is the fair market value of the property transferred to the trust, less the value of the retained annuity interest (a qualified interest) determined under IRC section 7520.

The regulations clarify certain issues with respect to qualified interests. They except trusts where the only interest retained is as a permissible recipient of distributions of income in the discretion of an independent trustee. A cumulative power of withdrawal does not meet the requirements of a qualified interest. The term of the interest must be for the life of the holder, a specified term of years or for the shorter of those periods.

The regulations permit an annuity or unitrust amount to increase during the term of the trust by up to 120 percent of the annuity amount or unitrust percentage paid for the preceding year. This may be very useful where the return on the property is expected to increase over time. If the increase is more than 120 percent, the excess is disregarded in valuing the annuity or unitrust payment.

Similarly, the regulations permit the annuity or unitrust payment to decrease over time, although no reference is made to prior year's payments.[4] This may be useful where the return on property will decrease, as with a depleting asset.

If the annuity or unitrust payment is for a period of years that exceeds the life expectancy of the annuitant, the value of the retained interest will be computed on the basis that the interest will terminate on the earlier of the death of the annuitant or the stated term.[5] This is important if the objective is to have a remainder interest with a value of zero.

A zero valuation for the remainder interest means that the retained interest equals the entire value of the property transferred. This is usually referred to as a "zero-out GRAT." With a true zero-out GRAT, no gift tax should be owing although, as discussed below, the IRS position is to the contrary. By playing with the valuation tables, it is possible to fix the amount of the annuity, in combination with the term of the trust, to result in a nontaxable remainder interest.

Zero-Out GRAT

Example: *A* creates a GRAT for a period of ten years. The annuity payments equal 15.31 percent of the initial fair market value of the trust corpus. Assuming the applicable federal rate is 8.6 percent, the value of the remainder will be zero. If the grantor is 60 years old, the annuity would have to be increased to 16.48 percent for the value of the remainder to be zero. If the grantor is 70 years old, the annuity would have to be 17.98 percent.

No Zero-Out GRUTs

Since a unitrust (GRUT) is a percentage of the trust property computed annually, the remainder interest could never be zero.

Duration of GRATs and GRUTs

Unlike the old-fashioned GRIT, the GRAT and GRUT are not limited to a maximum of ten years. As a practical matter, however, the duration of the GRAT or GRUT trust should be shorter than the life expectancy of the transferor. If the transferor dies before the expiration of the

term, then the full value of the trust would be includable in his or her gross estate.[6]

The period of the retained interest should be balanced against the fact that the longer the period of the retained interest, the smaller the value of the gift and the lower the gift tax. As with the common law GRIT, it would be beneficial to fund the trust with property that has substantial appreciation potential so that the actual gift received by the remaindermen (the children) will greatly exceed the value of the gift for gift tax purposes.

Computing the Value of the Interests

The computation of the GRAT and GRUT retained interest and gift amounts is based on the valuation tables in IRS Publications 1457 (Alpha Volume) and 1458 (Beta Volume), which tables have now been incorporated into the regulations.[7] The computations differ depending on whether there is an annuity or a unitrust and whether it is for a term of years or for life. Most GRATs and GRUTs will be for a term of years to avoid having the property included in the grantor's estate.

To determine the value of the retained interest in a GRAT, the starting point is to determine the current interest rate under IRC section 7520, which is published monthly in a revenue ruling; then use Table B of the Alpha Volume. Refer to the page for the applicable interest rate nd find the annuity factor under the appropriate term of years. (Computer programs are available to make the computations.)

For example, the annuity factor for a ten-year annuity, when the applicable interest rate is 8.6 percent, is 6.5322. That factor is then multiplied by the annuity amount. The result is the present value of the annuity. The remainder interest, or gift portion, is determined by subtracting the present value of the annuity from the fair market value of the principal.

In computing the retained interest in a GRUT, refer to Table D of the Beta Volume. The unitrust interest rate (adjusted payout rate) is used, rather than the applicable federal rate. The factor is determined by using the adjusted payout rate and the appropriate term of years. For example, the factor for an 8 percent payout for ten years is .434388. This factor is multiplied by the fair market value of the principal. The result is the present value of the remainder interest.

In valuing the common law GRIT (which may still be used for non-family members), Table B of the Alpha Volume is used. The determination of the factor is similar to that for the GRAT, except that the income interest factor is used rather than the annuity factor. For example, e factor for an income interest for a term of ten years, when the applicable federal interest rate is 8.6 percent, is .561770. This factor is then multiplied by the fair market value of the principal, resulting in the present value of the income interest.

GRAT Example: Paul, a 60-year-old man in good health, puts $1 million into a trust, retaining the right to receive $100,000 a year for 15 years. Upon the expiration of the term, his children receive the trust property. Assuming the applicable interest rate is 8.6 percent, the factor is 8.2546. The value of the retained interest is $825,460, leaving the value of the remainder at $174,540. If Paul's unified credit is available, there would be no federal gift tax. Assuming all of Paul's unified credit had been used, the gift tax on the transfer would be $46,653, which seems a small price to pay for the transfer of $1 million, plus any appreciation.

Even though the trust will qualify as a grantor trust under IRC sections 673-677, and Paul will pay income tax on whatever income the trust earns, Paul is no worse off than before he transferred the property. The income tax burden may be alleviated by funding the trust with property that does not generate income or generates an insubstantial amount of taxable income.

To the extent that Paul does not need the entire $100,000 annually, he could use the excess to fund a gift program for children and grandchildren, utilizing the annual exclusion.

GRUT Example: Assume the same facts as above, except Paul retains the right to 10 percent of the trust principal, determined and payable annually. Using Table D of IRS Publication 1458, the value of the remainder interest is $205,891, which is slightly more than the value of the remainder using a GRAT. This is so because the unitrust is a percentage of the trust principal rather than a fixed amount, and the payout rate is higher than the applicable federal rate. If the situation were reversed, i.e., the applicable federal rate was higher than the payout rate, the value of the remainder would be higher.

The common law GRIT is still available for non-family members and should be used if the situation warrants. By funding a GRIT with low-dividend/high-growth stock, the retained interest will be overvalued, resulting in the remainder interest being undervalued.

Layered Zero GRATs

As previously noted, a zero-out GRAT is one in which the present value of the annual annuity payments to the grantor equals the value of the property contributed to the GRAT. The effect of the zero-out GRAT is to substantially reduce the gift tax. The problem with the zero GRAT is that, if the grantor dies during the term of the GRAT, his or her estate includes all of the GRAT distributions and the entire balance of the GRAT assets.

A strategy to reduce this substantial estate inclusion is known as the two-year layered zero GRAT. The grantor establishes a two-year zero GRAT and, with each annual GRAT distribution to the grantor, the grantor creates a new two-year GRAT. At the end of each two-year period, the remaindermen (usually children) receive a distribution. This means that, over a ten-year period, the grantor will recycle GRAT distributions to create ten layered GRATs with nine distributions to the remaindermen. The result is a reduction in the grantor's estate at a low gift tax cost.

If, instead of using the layered GRAT strategy, the grantor had created a ten-year GRAT and died during the tenth year, the entire balance of the GRAT principal would be included in the estate since there would not be any distributions to the remaindermen. With the layered strategy, only the balance of the then existing two-year GRAT is included in the estate.

Gift Tax Consequences of Zero GRATs

An IRS revenue ruling[8] provides that, where the fixed amount to be paid from a trust in the form of an annuity to the grantor for the grantor's life will exhaust the corpus of the trust prior to the stipulated term of the trust, the value of the retained annuity interest is the present value of the right to receive the payments until the fund exhausts or until the prior death of the annuitant—rather than the value computed from actuarial tables based upon the stated term of the trust.

The regulation provides that, in such circumstances, it will be necessary to calculate a special IRC section 7520 annuity factor that takes into account the facts and circumstances that may exhaust the fund or trust.

The One Percent GRAT Solution

In IRS Letter Ruling 9239015, it was held that if there are adequate funds in the trust at the end of the two-year term, based on present value computations, so as not to exhaust the trust prior to its termination at the end of two years, Revenue Ruling 77-454 is not applicable to the trust. In the letter ruling, the aggregate payments from the two-year GRAT equaled 99.171 percent of the amount contributed to the trust, so that the trust fund was not exhausted prior to its termination. Although gift tax was owing, it was on less than one percent of the transfer, a small price to pay for the results accomplished. The benefit achieved is that the recycling of the annuity payments results in annual transfers to the remaindermen.

The letter ruling may be viewed as providing a safe harbor for structuring two-year layered zero-out GRATs. These GRATs should be structured so that one percent of the fund is not exhausted.

Funding Layered GRATs With Family Limited Partnership Interests

Generally, grantors will want to fund layered GRATs with property that is easily transferable at minimal expense. Stocks, bonds and marketable securities are therefore suitable. Generally, real estate is not suitable since the transfer process requires a flow of deeds, which means incurring transfer expenses and possibly complicating title.

Real estate, as well as other closely held family assets, are suitable when the assets are owned by a family limited partnership (FLP), and the GRAT is funded with FLP interests. The additional problem that arises when funding a GRAT with FLP interests is the issue of valuation. Initially, there will be a valuation expense, which will probably have to be reviewed and updated annually.

The use of layered GRATs funded with closely held hard-to-value assets, such as family limited partnership interests, could be very beneficial from an estate and gift tax planning perspective if it is expected that the underlying assets will substantially increase in value over a period of time. With the two-year layered GRAT, a portion of these assets is being transferred to remaindermen each year, starting in year two. Although the annual gift may be small, the cumulative gifts, coupled with the anticipated increases in value, may mean that a substantial amount of assets may be transferred at a low gift tax cost. In terms of estate tax, the savings are even more significant, since no part of the increased value is included in the gross estate.

Another important factor with funding GRATs with limited partner interests is that those interests are valued based upon minority and marketability discounts. This means that, if the underlying value of the FLP assets is $1 million, the effect of the discounts may reduce the FLP interest by anywhere from 30 percent to 50 percent or more.

Generation-Skipping Transfer Tax Trap

Although every grantor has a $1 million generation-skipping transfer tax (GSTT) exemption, there are several reasons why grantors should not allocate the GSTT exemption to GRATs, GRUTs and personal residence trusts and qualified personal residence trusts (PRTs and QPRTs). (PRTs and QPRTS are exceptions to the general GRAT and GRUT rules of IRC section 2702. With a PRT or QPRT, the grantor transfers his or her personal residence to the trust and retains a term of years or life interest.)

The Estate Tax Inclusion Period (ETIP)

The ETIP rules discourage allocation of the GSTT exemption to PRTs, QPRTs, GRATs and GRUTs. The ETIP is the period during which, should death occur, the value of the transferred property is includable in the grantor's estate. If the grantor dies during the trust term, the property is included in the grantor's estate.

The regulations provide that a GSTT exemption allocation, although made at the time of the transfer, is not effective until the termination of the ETIP. If the trust increases in value, then the allocation will not shield the increased value from GSTT.[9] Allocating the exemption to such interests is not tax efficient.

Example: Mary creates a ten-year generation-skipping GRAT for her grandchildren to which she transfers $1 million, allocating her $1 million GSTT exemption to the transfer. Mary files a gift tax return reporting the transfer and the allocation and paying the gift tax. At the end of the ten-year term, the GRAT assets, which have now increased in value to $1.5 million, are distributed to the grandchildren.

The distribution to the grandchildren is a trust termination subject to GSTT. The $1 million GSTT exemption is allocated at the time of the termination, notwithstanding the allocation at the time of the transfer. The sum of $500,000 is therefore subject to the 55 percent GSTT ($275,000), leaving only $225,000 for the grandchildren.

GSTT Exemption Leveraging Strategy With Life Insurance

The preferred planning is to leverage the use of the GSTT exemption with an irrevocable life insurance generation-skipping trust (ILIGST). Provided the ILIGST is properly structured, a $1 million transfer to the ILIGST to purchase life insurance on the life of the grantor will result in the life insurance death benefit passing free of GSTT.

Example: Mary creates an ILIGST, which she funds with a transfer of $1 million. The trust income is for the benefit of her two children for their lives and then passes outright to her four grandchildren. The ILIGST purchases a whole life insurance policy on the life of Mary with a death benefit of $13 million.

Mary has not used any part of her unified credit ($600,000 exemption equivalent). On her gift tax return she allocates all of her $1 million GSTT exemption to the transfer. Since Mary has not used any part of her unified credit, she pays a gift tax of $153,000 on the taxable portion of the gift ($400,000).

Fifteen years later Mary dies, and the ILIGST collects the death benefit and pays all the income to the two children for their lives. Both children die within ten years thereafter, and the ILIGST assets (then amounting to $20 million) are distributed to the four grandchildren. There are no estate taxes or GSTT owing at the time of Mary's death or on the deaths of the two children.

Observation

By investing in life insurance owned by an ILIGST, Mary has leveraged her $1 million GSTT exemption into a $20 million benefit for her grandchildren at a gift tax cost of $153,000. If Mary had previously used her unified credit, the gift tax cost increases to $407,800 (assuming her total taxable gifts are $1,600,000).

Conclusion

The GRAT is an effective device for transferring property to junior family members at a discounted gift tax cost. This device produces even more gift tax savings when structured as a zero-out GRAT. The tax savings improve when the recycled layered two-year GRAT strategy is used. The transfer tax results will improve dramatically when FLP interests are used to fund the GRATs.

Endnotes

1. IRC §§ 2701-2704.
2. Reg. § 25.2702-5.
3. Reg. § 25.2702-2(a)(3).
4. Reg. § 25.2702-3(e), ex. 3.
5. Reg. § 25.2702-3(e).
6. IRC § 2036(a).
7. Reg. § 25.7520-1(c).
8. Rev. Rul. 77-454, 1977-2 CB 351; Reg. § 20.7520-3(b)(2)(i).
9. Reg. § 26.2632-1(c).

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