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## LAYERED GRATS — BIG GIFT AND ESTATE PLANNING BENEFITS


*Myron Kove, Esq. and James M. Kosakow, Esq.**


The grantor retained annuity trust or GRAT is an effective planning strategy for transferring assets to the next generation at a discounted gift tax cost. A GRAT is a transfer to a trust in which the grantor retains an interest for a term of years or for life with the remainder to children. If properly structured, only the discounted value of the remainder interest is subject to gift tax.

The gift tax benefits are significantly improved when the remainder interest has a near zero value and when near zero GRATs are layered. Layering is the creation of short term GRATs by recycling GRAT distributions into new short term GRATs as explained below.

### *General Valuation Rule*

For purposes of estate and 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, with both parties having knowledge of all relevant factors. Treas. Reg. § 25.2512-1.

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 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 § 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. Treas. Reg. § 25.7520-1

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 § 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 Section 2702 Valuation Rules*

IRC § 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.

For IRC § 2702 to apply, an interest must be retained by the transferor or an applicable family member. Treas. Reg. § 25.2702-2(a)(3) clarifies that "retained" means held by the same individual both before and after the transfer. 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. Treas. Reg. § 25.2702-2(d) (Ex. 3).


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### 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 § 7520, and subtracted from the value of the transferred property. Because the value 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.

### Special Valuation Examples

The following examples, taken from the regulations, illustrate the application of the special valuation rules:

***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 § 7520.

### Zero-Out GRATs

The object is to reduce the value of the remainder interest so as to decrease the value of the gift. The ultimate objective is to reduce the value of the remainder to zero or as close to zero as possible so as to eliminate any taxable gift.

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. Using 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.

***Example 3:*** A creates a GRAT for a period of ten years. The annuity payments equal 15.31% of the initial fair market value of the trust corpus. Assuming the applicable federal rate is 8.6%, 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% for the value of the remainder to be zero. If the grantor is 70 years old, the annuity would have to be 17.98%.

### 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

As a practical matter, the duration of the GRAT or GRUT 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 is included in his or her gross estate under IRC § 2036(a).

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. It is also beneficial to fund the trust with property that has substantial appreciation potential so that the actual gift received by the remainder persons (the children) on the expiration of the GRAT term 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. Treas. Reg. § 25.7520-1(c). 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 the current interest rate under IRC § 7520, which is published monthly in a revenue ruling. Using Table B of the Alpha Volume, refer to the page for the applicable interest rate, and 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% 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.

### GRAT Example

***Example 4:*** Paul, a 60 year old man in good health, puts $1,000,000 into a GRAT, 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%, the factor is 8.2546. The value of the retained interest is $825,460, leaving the value of the remainder (the taxable gift) at $174,540. If Paul's unified credit is available, there is no federal gift tax payment. Assuming all of Paul's unified credit had been used, the gift tax on the transfer would be almost $66,000, a small price to pay for the transfer of $1,000,000, plus any appreciation.

Even though the trust will qualify as a grantor trust under IRC §§ 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.

### 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 equal the value of the property contributed to the GRAT. The effect of the zero-out GRAT is to eliminate 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 will establish a two-year zero GRAT. 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 remainder persons (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 remainder persons. 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 remainder persons. 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

The IRS position is set forth in Rev. Rul. 77-454, 1977-2 CB 351 and Treas. Reg. § 20.7520-3(b)(2)(i). The revenue ruling 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 Section 7520 annuity factor that takes into account the facts and circumstances that may exhaust the fund or trust.

### The One Percent GRAT Solution

IRS Private Letter Ruling 9239015 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, Rev. Rul. 77-454 is not applicable to the trust. In the letter ruling, the aggregate payments from the two-year GRAT equaled 99.171% of the amount contributed to the trust so that the trust fund was not exhausted prior to its termination. Although gift tax is 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

Generally, grantors will want to fund layered GRATs with property that is easily transferable at minimal expense and which may increase significantly in the short term, such as marketable securities. The result is that GRAT distributions during the term use a smaller percentage of the trust property leaving a larger portion for distribution to the remainder persons.

*Example 5:* Mary creates a near zero (99%) GRAT funded with XYZ stock valued at $100,000. The value of the remainder interest under the IRS tables is $1,000. The stock significantly increases in value during the GRAT term. The GRAT distributions to John are $99,000. The trust balance of $20,000 passes to the children.

### *Generation-Skipping Transfer Tax Trap*

Although every grantor has a $1 million generation-skipping transfer tax (GSTT) exemption, grantors should not allocate the GSTT exemption to GRATs, GRUTs and personal residence trusts and qualified personal residence trusts (PRTs and QPRTs), due to the rules on the estate tax inclusion period. (PRTs and QPRTs are exceptions to the general GRAT and GRUT rules of IRC § 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 includible 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. Treas. Reg. § 26.2632-1(c). Allocating the exemption to such interests is not tax efficient.

*Example 6:* Mary creates a ten-year generation-skipping GRAT for her grandchildren to which she transfers $1 million and allocates 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% GSTT ($275,000), leaving only $225,000 for the grandchildren.

### *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.

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* *Messrs. Kove and Kosakow are members of the firm of KOVE & KOSAKOW, LLC, with offices in New York City and Westport, Connecticut. The firm's web site is www.kovkos.com.*

*Myron Kove is an estate planning attorney practicing in New York City. He is the executive editor of* ***Insights & Strategies****, a nationally recognized monthly financial and estate planning newsletter for professionals. He is also co-author of the recently published* ***Real Estate Professionals' Tax Guide****, published by Warren Gorham & Lamont. Mike received his J.D. degree from Harvard Law School and his LL.M. and A.B. degrees from New York University.*

*James M. Kosakow is admitted to practice in Connecticut, New York, Florida, the District of Columbia and before the U.S. Tax Court. He is a frequent contributor to estate planning publications. Jim received his Bachelors degree from Connecticut College and his law degree from Benjamin N. Cardozo School of Law at Yeshiva University.*

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