

**Gift/Estate Tax Planning After the “2012” Tax Act
And
Creative GRAT Structures**

Denver Estate Planning Council

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GIFT AND ESTATE TAX PLANNING AFTER THE “2012” TAX ACT

A. History of Gift and Estate Tax Rules

Until 1998, the gift and estate tax exemption (also known as the “unified credit”) had been stuck at \$600,000. The 1997 Taxpayer Relief Act (the “1997 Act”) scheduled increases to the unified credit, and would gradually raise it to \$1,000,000 in 2006. Further, the marginal tax rates applicable to gifts and estates started at 18 percent and went up to 55 percent for aggregate transfers exceeding \$3,000,000.

When the Economic Growth and Tax Relief Reconciliation Act of 2001 (the “2001 Act”) was enacted, the gift tax exemption was immediately increased to \$1,000,000, and the estate and GST tax exemptions were set to gradually increase to \$3,500,000 in 2009. At that time, the gift, estate and GST exemptions were no longer unified. The estate and GST exemptions were unified and would increase together, but the gift tax exemption remained fixed at \$1,000,000. Thus, one could leave more at death than could be given away free of tax during life. The 2001 Act also reduced the maximum gift/estate/GST tax rate to 50 percent in 2002 and thereafter reduced the rate by an additional 1 percent per year until 2007, at which time the maximum tax rate remained at 45 percent through 2009. In 2010, the estate tax and GST tax (but not the gift tax) no longer applied, except in the case of qualified domestic trusts. A few unfortunate souls (with lucky heirs) paid no estate tax in 2010. However, the 2001 Act was set to expire in full at the end of 2010, reverting back to pre-2001 law.

In December 2010, the Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the “2010 Tax Act”) reinstated the estate tax beginning in 2011, but at a 35 percent rate and with a \$5,000,000 unified gift, estate and GST tax exemption, indexed for inflation (\$5,120,000 in 2012). Thus, the estate tax exemption over time has been:

<u>Year</u>	<u>Exemption</u>
2002	\$1,000,000
2003	\$1,000,000
2004	\$1,500,000
2005	\$1,500,000
2006	\$2,000,000
2007	\$2,000,000
2008	\$2,000,000
2009	\$3,500,000
2010	no estate tax
2011	\$5,000,000
2012	\$5,120,000

However, the 2010 Tax Act was set to expire on January 1, 2013. Absent Congressional action, the estate tax regime existing immediately prior to the enactment of the 2001 Act would be resurrected: \$1,000,000 exemptions and a 55% top marginal rate.

B. American Taxpayer Relief Act of 2012

On January 1, 2013, Congress passed the "American Taxpayer Relief Act of 2012" (the "2012 Act"), just after the nation went over the "fiscal cliff." The 2012 Act repealed the sunset provisions of the 2001 and 2010 tax acts (repealed the repeal?), making permanent tax laws that have been in effect for the last decade, with some modifications. Importantly, the 2012 Act is "permanent" (as much as any law can be permanent), and is not set to expire in two or ten years. These are laws with which we can plan. The 2012 Act does the following:

1. Exemptions Unified: The 2012 Act keeps the gift, estate and generation-skipping transfer (GST) exemptions unified at \$5,000,000, indexed for inflation from 2011. The inflation adjustment results in a unified exemption of \$5,250,000 for 2013, up from \$5,120,000 in 2012.

2. Tax Rates: The 2012 Act permanently increased the top gift and estate tax rates from 35% to 40% (which is a net decrease compared to 2009's 45% rate). Since the GST tax rate is the highest marginal estate tax rate, the GST tax rate also increased to 40%.

3. Portability: The 2012 Act makes "portability" permanent. This was created as part of the 2010 Act, and allows the estate of the first spouse to die to transfer his or her unused estate tax exemption to his or her surviving spouse. This is useful if (a) the deceased spouse did not have enough assets to use up his/her exemption or (b) the deceased spouse left his/her estate directly to the surviving spouse rather than a bypass trust to utilize the estate tax exemption.

The portability provision applies beginning in 2011, and the other provisions apply to estates of decedents dying, generation-skipping transfers, and gifts made after December 31, 2012.

The 2001 Act made several other important changes, which were set to expire on December 31, 2012, but are now a permanent part of the law:

- The limited deduction for a "qualified family owned business" (QFOB), and all its complications, is gone. It was repealed by the 2001 Act, but set to be reinstated in 2013 when the 2010 Tax Act expired.

- Qualified severances: These allow a partially GST exempt trust to be split into two trusts, one fully exempt and one non-exempt.

- Automatic GST allocation rules and GST trust elections: These rules automatically allocate GST exemption to trusts that are likely to pass multiple generations, and allow elections to automatically allocate (or not allocate) GST exemption to trusts. In many respects, these rules have proved more confusing than helpful, but they are here to stay.

- State estate taxes remain a deduction rather than a credit. This means less revenue for the states, more for the U.S. Treasury, and higher overall taxes in states that impose an estate/inheritance tax.

- Expansion of conservation easement rules for estate tax deductions: Geographic limitations removed as long as the property is located in the US or a US possession.

• Number of allowable shareholders or partners for Section 6166 purposes increased from 15 to 45. In order to be a closely held business for Section 6166 purposes, either 20% of partnership capital or voting stock of a corporation must be included in estate, or the entity must have 45 or fewer partners/shareholders.

C. Impact of Tax Act on Estate Planning

First, the gift, estate and GST exemptions are now indexed for inflation. In 2013, they are \$5,250,000. If inflation is a modest 2%, in 20 years the exemptions will be \$7.65 million. At 3% inflation they will be \$9.2 million, at 4% inflation they will be \$11.06 million, and at 5% they will be \$13.26 million. Of course, these amounts are double for married couple. In other words, 20 years from now the combined exemptions for a married couple will be \$15 million-\$26 million!

Additional gifts can be made *every year*. Not only will we remind our clients to make their annual exclusion gifts (which have increased to \$14,000 per donee this year), but also their increased gift exemptions. If inflation is just 2% this year, the combined gift exemptions of a married couple will increase by over \$200,000 next year! A married couple with 3 children and 7 grandchildren could make \$280,000 of annual exclusion gifts, and another \$200,000-\$400,000 per year of gifts using their increased gift exemptions, depending on the inflation rate.

Other transactions (such as sales for notes) can be done on a larger scale. The “10 to 1” rule of thumb for sales to grantor trusts will be a non-issue for most clients.

Despite the “portability” rules, we will still recommend our clients use credit shelter trusts as part of their estate plan. This is because: (1) unused GST exemption is not portable; (2) the trust provides protection against creditors; and (3) the income and appreciation of the trust assets escapes estate tax.

The 2012 Act did not address other items that have been on the current and prior administrations’ radars, such as:

- The duration of GRATs: 10 year minimum? Required minimum gift?
- The duration of GST exempt dynasty trusts: Adding a limit for estate/GST tax purposes?
- Valuation discounts applicable to gifts of interests in family limited partnerships or other entities: Eliminating or limiting discounts?
- Changing the rules surrounding grantor trusts.

D. Conclusions

With high (and increasing) gift tax exemptions, low interest rates, and the continued ability to use grantor trusts, GRATs, and discounted FLPs, the opportunity and ability to transfer wealth has never been greater. Any of these doors can be closed by new legislation at any time. It is our job to advise clients to take advantage of these opportunities.

DECREASING SHORT-TERM GRATS AND DISCLAIMER GRATS

A. GRAT Basics

A "grantor retained annuity trust" (GRAT) is a trust in which the grantor retains the right to receive fixed annuity payments, payable at least annually, for a term of years (an annuity interest). At the end of the term, the remaining trust principal is distributed to the remainder beneficiaries (such as the grantor's descendants) or held in further trust for their benefit. If the grantor survives the term, the remaining trust property is excluded from his or her estate for federal estate tax purposes. If the grantor fails to survive the term, the trust property may be included in his or her gross estate under IRC Section 2036.

B. Gift and Estate Tax Consequences

In general, the gift made to the remaindermen upon creation of a GRAT is equal to the value of the property transferred to the GRAT less the value of the interest retained by the grantor.

1. Application of IRC Section 2702

If a transfer of an interest in trust is made to a member of one's family, then the value of any interest in the trust retained by the transferor (or an applicable family member) is determined under IRC Section 2702. Under that section, the subtraction method is used to determine the value of the transferred interest; that is, the value of the retained interest is subtracted from the value of the property transferred to determine the value of the transferred interest. Any interest retained by the grantor that is a "qualified interest" is valued under the tables in IRC Section 7520 (Publication 1457, Actuarial Tables, Book Aleph), and any interest retained by the grantor that is not a qualified interest is valued at zero. A right to receive fixed amounts payable not less frequently than annually is a qualified interest.¹ Thus, the annuity retained by the grantor in a GRAT is a qualified interest and will be valued using the factors contained in the tables in IRC Section 7520. Those tables determine the present value of the annuity using the Section 7520 rate as the discount rate. The factors are based on the "Section 7520 rate," which is equal to 120 percent of the mid-term AFR, compounded annually, rounded up to the nearest 2/10ths of one percent.

In contrast, if the grantor instead retained the right to all the income earned by the trust, the income interest would not be a qualified interest and it would be valued at zero for purposes of determining the gift made. Because the grantor's interest is valued at zero,

¹ IRC §2702(b)(1).

there is nothing to subtract from the value of the property transferred to the trust in determining the taxable gift to the remaindermen; in other words, the gift to the remaindermen would equal the full value of the property transferred to the trust.

Note that if the annuity is paid other than annually, such as semiannually, quarterly, monthly, or weekly, then the annuity factor must be adjusted (using Table K in Publication 1457) in order to compute the annuity interest involved. For example, if the annuity is payable in monthly installments, then the annuity factor must be multiplied by the appropriate adjustment factor in Table K to compute the adjusted annuity factor, which is used to value the annuity interest.

2. Remainder and Reversionary Interests

The grantor could retain a reversionary interest in a GRAT. That is, the GRAT provides that if the grantor fails to survive the GRAT term, the GRAT will terminate and the grantor's estate will receive the GRAT property, causing the property to pass under his or her will or revocable trust. As stated above, if the grantor fails to survive the GRAT term, the entire trust property may be included in his or her gross estate. Thus, by retaining a reversionary interest and causing the GRAT property to pass under the grantor's will or revocable trust, it may be possible to defer or eliminate estate tax through the use of the marital and charitable deductions.

If the grantor retains a reversionary interest in a GRAT, the interests in the GRAT will consist of three components: the annuity interest for the shorter of a term of years or the grantor's life, the remainder (paid to the remaindermen if the grantor survives the term), and the reversion (paid to the grantor's estate if the grantor fails to survive the term). Only the annuity interest is subtracted from the value of the property transferred to the GRAT in determining the taxable gift. The value of the reversion retained by the grantor does not reduce the value of the gift because a reversion is not a qualified interest under IRC Section 2702; the reversion is valued at zero for purposes of determining the value of the interest retained by the grantor. Thus, the taxable gift includes the value of the remainder and the value of the reversion. Put differently, the value of the annuity is reduced due to the possibility that the grantor will not survive for the entire term, in which case he or she may not receive the full amount of all of the annuity payments, thus decreasing the present value of the annuity interest. The decrease in the annuity value is equal to the reversion value.

EXAMPLE:

A 60-year-old person transfers \$1 million to a 10-year GRAT that pays him \$132,032 per year. If he fails to survive the 10-year term, the property reverts to his estate. The Section 7520 rate is 5.4 percent. Based on the Actuarial Tables, Book Aleph, Publication 1457, the interests created under such GRAT would have the following values:

Value of annuity interest = \$932,518 (\$132,032 x 7.0628) (Table H)

Value of remainder interest = \$0

Value of reversionary interest = \$67,482 (\$1 million - \$932,518 annuity interest - \$0 remainder)

If the grantor retains the right to an annuity for a fixed term regardless of whether he or she is living (i.e., no reversion is created), the interests in the GRAT will consist of two components: (1) the annuity interest for a fixed term of years payable to the grantor or, if the grantor does not survive the term, to the grantor's estate and (2) the remainder interest (paid at the end of the term). Under *Walton v. Commissioner*,² the value of the annuity interest is based on the stated term of the GRAT and is not decreased by the possibility that the grantor will not survive for the entire term. The annuity interest is subtracted from the value of the property transferred to the GRAT in determining the taxable gift. Because there is no reversion, the taxable gift includes only the value of the remainder. Such a GRAT is often referred to as a “Walton GRAT,” or “gift-free GRAT.”

3. Estate Inclusion

IRC Sections 2036 and 2033 apply to a GRAT where the grantor does not survive the GRAT term. IRC Section 2033 would include the present value of the remaining annuity payments (or all the trust property if the grantor retains a reversion). However, Section 2036 would not merely include the present value of the remaining annuity payments but would include the amount of property necessary to produce a sufficient amount of income (using the prevailing Section 7520 rate) to fund the remaining annuity payments from such income.³ Thus, the amount included under IRC Section 2036 is equal to the annuity divided by the Section 7520 rate at the grantor's death.

4. Maximizing Benefits of a GRAT

(a) Source of Benefits

The Section 7520 rate is the rate of return the Service assumes the GRAT will realize (i.e., the discount rate) for purposes of determining the value of the annuity interest. A GRAT will serve to transfer property free of gift tax to the remaindermen if and only if the property in the GRAT produces income and appreciation at a rate greater than the Section 7520 rate.

² 115 T.C. No. 41 (2000).

³ See Rev. Ruls. 82-105, 1982-1 C.B. 133, 76-273, 1976-2 C.B. 268, TAM 200210009 (Nov. 19, 2001).

(b) **Economically Zeroed-Out Walton GRATs**

An economically zeroed-out GRAT (or "zeroed-out" GRAT) is a fixed-term (not the shorter of a term or the grantor's life) GRAT in which the annuity is set so that the present value of the annuity payments, using the Section 7520 rate as the discount rate, is exactly equal to the value of the assets transferred to the GRAT, and thus the remainder (and gift) is zero. This annuity amount can be determined by dividing the amount transferred to the GRAT by the term factor in Table B of the Actuarial Tables, Book Aleph, Publication 1457.

If the GRAT's rate of return equals the Section 7520 rate, then, by definition, the last annuity payment to the grantor will consume the last assets remaining in the GRAT, leaving nothing for the remaindermen. If the property in the GRAT appreciates at a rate greater than the Section 7520 rate, some property will be left to pass to the remaindermen at the end of the GRAT term.

EXAMPLE:

Gary transfers \$10 million to a GRAT that pays an annuity of \$1,320,324 per year for 10 years. Based on a Section 7520 rate of 5.4 percent, the value of the annuity is \$10 million and the value of the remainder is zero.

If the GRAT's rate of return on its assets is 5.4 percent (the rate assumed for purposes of determining the remainder), nothing will be left for the remaindermen.

<u>Year</u>	<u>Start of Year</u>	<u>Growth</u>	<u>Annuity</u>	<u>End of Year</u>
1	\$ 10,000,000	\$ 540,000	\$(1,320,324)	\$ 9,219,676
2	\$ 9,219,676	\$ 497,863	\$(1,320,324)	\$ 8,397,215
3	\$ 8,397,215	\$ 453,450	\$(1,320,324)	\$ 7,530,341
4	\$ 7,530,341	\$ 406,638	\$(1,320,324)	\$ 6,616,656
5	\$ 6,616,656	\$ 357,299	\$(1,320,324)	\$ 5,653,631
6	\$ 5,653,631	\$ 305,296	\$(1,320,324)	\$ 4,638,604
7	\$ 4,638,604	\$ 250,485	\$(1,320,324)	\$ 3,568,764
8	\$ 3,568,764	\$ 192,713	\$(1,320,324)	\$ 2,441,154
9	\$ 2,441,154	\$ 131,822	\$(1,320,324)	\$ 1,252,653
10	\$ 1,252,653	\$ 67,643	\$(1,320,324)	\$ (28)

However, if the GRAT's rate of return on its assets is 10 percent, the remaindermen will receive \$4,894,864 at the end of the GRAT term. Although the Service expected the remaindermen to receive nothing from the GRAT (because the actuarial value of the remainder was zero at the outset of the GRAT), the remaindermen receive nearly \$5 million for no gift tax cost.

<u>Year</u>	<u>Start of Year</u>	<u>Growth</u>	<u>Annuity</u>	<u>End of Year</u>
1	\$ 10,000,000	\$ 1,000,000	\$(1,320,324)	\$ 9,679,676
2	\$ 9,679,676	\$ 967,968	\$(1,320,324)	\$ 9,327,320
3	\$ 9,327,320	\$ 932,732	\$(1,320,324)	\$ 8,939,728
4	\$ 8,939,728	\$ 893,973	\$(1,320,324)	\$ 8,513,378
5	\$ 8,513,378	\$ 851,338	\$(1,320,324)	\$ 8,044,392
6	\$ 8,044,392	\$ 804,439	\$(1,320,324)	\$ 7,528,507
7	\$ 7,528,507	\$ 752,851	\$(1,320,324)	\$ 6,961,034
8	\$ 6,961,034	\$ 696,103	\$(1,320,324)	\$ 6,336,814
9	\$ 6,336,814	\$ 633,681	\$(1,320,324)	\$ 5,650,171
10	\$ 5,650,171	\$ 565,017	\$(1,320,324)	\$ 4,894,864

(c) **Re-GRATs (or Rolling GRATs)**

The Re-GRAT technique is simply a series of short-term (2-year) GRATs. Each successive GRAT is funded with the annuity payments received from the existing GRATs. The annuity payments are continuously redirected to new GRATs, and potentially out of the grantor's taxable estate, significantly increasing the benefit of the GRAT technique.

- (i) **Reduced Mortality Risk.** Because these GRATs have very short terms, the probability of the grantor's death during a particular GRAT term is greatly reduced, and the mortality risk associated with GRATs is consequently reduced.
- (ii) **Less Investment Risk.** The Re-GRAT technique is also superior to a single GRAT in the event of a year of poor investment returns. With a single GRAT, even a single year of poor investment returns will greatly increase the future returns required in order for the GRAT to benefit the remaindermen. Once the GRAT's returns are "in the hole," it is very difficult for it to recover enough to beat the Section 7520 hurdle rate. Using the Re-GRAT technique, a year of poor investment returns will only affect the GRATs in existence at that time; successive GRATs are unaffected and get a fresh start with a new, lower baseline.

For example, assume the annual rates of return realized by Gary's 10-year GRAT (described above) are 3%, -7%, 8%, 6%, 10%, -2%, 15%, 12%, 9% and 8%, which yield an average return of 6.2%. However, because in some years the rate of return was less than the 5.4% hurdle rate (including losses in 2 years), the GRAT would leave nothing for the remaindermen at the end of the term-- in fact it would run out of money after 9 years.

<u>Year</u>	<u>Start of Year</u>	<u>Growth</u>	<u>Annuity</u>	<u>End of Year</u>
1	\$ 10,000,000	\$ 300,000	\$(1,320,324)	\$ 8,979,676
2	\$ 8,979,676	\$ (628,577)	\$(1,320,324)	\$ 7,030,775
3	\$ 7,030,775	\$ 562,462	\$(1,320,324)	\$ 6,272,913
4	\$ 6,272,913	\$ 376,375	\$(1,320,324)	\$ 5,328,965
5	\$ 5,328,965	\$ 532,896	\$(1,320,324)	\$ 4,541,537
6	\$ 4,541,537	\$ (90,831)	\$(1,320,324)	\$ 3,130,383
7	\$ 3,130,383	\$ 469,557	\$(1,320,324)	\$ 2,279,616
8	\$ 2,279,616	\$ 273,554	\$(1,320,324)	\$ 1,232,847
9	\$ 1,232,847	\$ 110,956	\$(1,320,324)	\$ 23,479
10	\$ 23,479	\$ 1,878	\$(1,320,324)	\$ (1,294,966)

Instead now assume the \$10 million was contributed to a 2-year GRAT (GRAT 1), at the end of year 1 the \$5,408,621 annuity was contributed to a second 2-year GRAT (GRAT 2), at the end of year 2 the second annuity of GRAT 1 and the first annuity of GRAT 2 were contributed to a third GRAT, and so on for 10 years. Using the same annual rates of return as above (3%, -7%, 8%, 6%, 10%, -2%, 15%, 12%, 9% and 8%), the remaindermen would receive a total of \$2,803,800 from the GRATs. (The bottom line in the charts below show the amounts remaining at the end of each GRAT.)

	<u>1st GRAT</u>	<u>2nd GRAT</u>	<u>3rd GRAT</u>
Funding	\$ 10,000,000	\$ 5,408,621	\$ 7,474,301
Growth - 1st year	\$ 300,000	\$ (378,603)	\$ 597,944
1st Annuity	\$ 5,408,621	\$ 2,925,318	\$ 4,042,566
Amount after 1 year	\$ 4,891,379	\$ 2,104,699	\$ 4,029,678
Growth - 2nd year	\$ (342,397)	\$ 168,376	\$ 241,781
2nd Annuity	\$ 4,548,982	\$ 2,273,075	\$ 4,042,566
Amount after 2 years/benefit of GRATs	\$ -	\$ -	\$ 228,893

<u>4th GRAT</u>	<u>5th GRAT</u>	<u>6th GRAT</u>
\$ 6,315,642	\$ 7,458,458	\$ 7,449,889
\$ 378,938	\$ 745,846	\$ (148,998)
\$ 3,415,891	\$ 4,033,997	\$ 4,029,363
\$ 3,278,689	\$ 4,170,306	\$ 3,271,528
\$ 327,869	\$ (83,406)	\$ 490,729
\$ 3,415,891	\$ 4,033,997	\$ 3,762,257
\$ 190,666	\$ 52,903	\$ -

<u>7th GRAT</u>	<u>8th GRAT</u>	<u>9th GRAT</u>
\$ 8,063,360	\$ 8,123,423	\$ 8,754,818
\$ 1,209,504	\$ 974,811	\$ 787,934
\$ 4,361,166	\$ 4,393,652	\$ 4,735,150
\$ 4,911,698	\$ 4,704,582	\$ 4,807,602
\$ 589,404	\$ 423,412	\$ 384,608
\$ 4,361,166	\$ 4,393,652	\$ 4,735,150
\$ 1,139,936	\$ 734,342	\$ 457,061
	Total \$2,803,800	

Assuming the trust receiving the GRAT remainders achieves the same returns on its investments, the remainder would have a total of \$3,329,733 at the end of 10 years, including the growth.

Year	SOY	Growth	Remainder received	EOY
1	\$ -	\$ -	\$ -	\$ -
2	\$ -	\$ -	\$ -	\$ -
3	\$ -	\$ -	\$ -	\$ -
4	\$ -	\$ -	\$ 228,893	\$ 228,893
5	\$ 228,893	\$ 22,889	\$ 190,666	\$ 442,448
6	\$ 442,448	\$ (8,849)	\$ 52,903	\$ 486,502
7	\$ 486,502	\$ 72,975	\$ -	\$ 559,477
8	\$ 559,477	\$ 67,137	\$ 1,139,936	\$ 1,766,550
9	\$ 1,766,550	\$ 158,990	\$ 734,342	\$ 2,659,882
10	\$ 2,659,882	\$ 212,791	\$ 457,061	\$ 3,329,733

By using Re-GRATs instead of a single 10-year GRAT, the amount transferred to the remaindermen is increased from \$0 to \$3.3 million!

- (iii) **Interest Rate Risk.** The Section 7520 rate is likely to change over time. Any increase in this interest rate will increase the “hurdle” rate of return the GRATs must achieve to be successful.

However, this risk is offset by the investment benefits of re-GRATs described above. In the example above, even if we assume the 7520 rate increases by .2% every year, the total of the rolling GRAT remainders would be \$2,122,905, and the remaindermen would have \$2,524,668 at the end of 10 years, including growth (compared to zero from a fixed term GRAT). With .4% annual increases in the 7520 rate, these figures are \$1,455,002 and \$1,756,911, respectively.

(d) **Increasing Rolling GRATs**

Regulation Section 25.2702-3(b)(1)(ii) permits the GRAT annuity to increase annually by up to 20% over the preceding year's annuity (an "increasing GRAT"). Using an increasing GRAT will increase the amount of the remainder when the assets are consistently appreciating, because more of the assets remain in the GRAT for a longer period of time to beat the 7520 rate.

For example, assume a \$10 million 2-year GRAT has a fixed annuity of \$5,408,621 per year (5.4% 7520 rate). If the GRAT achieves a rate of return of 10% each year, \$741,895 will pass to the remaindermen after two years. Alternatively, the GRAT could have an annuity that starts out lower and increases by 20% in the second year. In this case, the annuity would be \$4,928,536 in the first year and \$5,924,143 in the second year. If the GRAT achieves a rate of return of 10% each year, \$764,367 will pass to the remaindermen after two years-- \$22,472 more than the level-payment GRAT. (The results are more pronounced over several years.)

However, an increasing GRAT does not always pay off. If the GRAT has poor investment performance, it would be better to receive a larger annuity sooner so that the assets can be recontributed to a new GRAT with a fresh new baseline. For example, if the GRAT's investments achieve a rate of return of .2% in the first year, that GRAT is unlikely to make up the difference in the second year in order to leave a benefit to the remaindermen. Thus, a higher annuity in the first year would be preferable to a lower one that will increase in the second year because the grantor would have more assets to recontribute to a new GRAT that is not "in the hole."

Using our roller-coaster returns from above (3%, -7%, 8%, 6%, 10%, -2%, 15%, 12%, 9% and 8%), a series of 10 2-year rolling GRATs with increasing annuity payments would leave a total of \$2,772,129 for the remaindermen, while using level-payment GRATs would leave them \$2,803,800.

Because one cannot reliably predict rates of return, using an increasing annuity cannot be relied upon to increase the benefits of GRATs.

(e) **Decreasing Rolling GRATs**

As explained above, one of the advantages of a two-year GRAT is that if a GRAT has a year of poor investment returns, the net benefit will be greatly reduced, if not eliminated. One would prefer to get the assets back out of the GRAT so that they can be put into a new GRAT as soon as possible with a new baseline. For example, if a GRAT is funded with \$1 million and the next day the assets decline in value to \$700,000, and eventually recover to \$1 million again, the GRAT would not be successful because there was zero net growth-- nothing would pass to the remaindermen. Instead, we would prefer to get the assets out of the GRAT and put them into a new GRAT with the new starting value of \$700,000. That way, if the assets recover to \$1 million in value, the GRAT would have \$300,000, or 42% growth, resulting in a tidy amount passing to the remaindermen.

In the case of declining returns, a two-year GRAT will cause more than half of the original value to be distributed to the grantor after one year, and the rest after two years. Each annuity payment could be "re-GRAT-ed" into another GRAT as it is received. However, we would prefer to get as much out of the GRAT as early as possible so that if values are down the assets can get into a GRAT with a new baseline quickly. It is unclear whether a one-year GRAT would be permissible.

Regulation Section 25.2702-3(d)(4) provides, "The governing instrument must fix the term of the annuity or unitrust and the term of the interest must be fixed and ascertainable at the creation of the trust. The term must be for the life of the holder, for a specified term of years, or for the shorter (but not the longer) of those periods." The reference to a term of "years" suggests that a GRAT must have a term longer than one year. In Kerr v. Commissioner,⁴ the taxpayer created a GRAT with a term of 1 year and 2 days. The

⁴ 113 T.C. 450 (1999), aff'd 292 F3d 490 (5th Cir. 2002).

validity of the GRAT was not at issue in the case, suggesting that there was no issue. However, most practitioners create GRATs with a minimum term of two years.

Instead, by using a decreasing GRAT, we can come close to replicating a one-year GRAT, if such a GRAT is not otherwise permitted. Specifically, the GRAT could provide for a payment equal to 90% of the initial trust value at the end of the first year, and a second payment calculated so that the present value of the two payments equals the value of the property contributed. For example, if the 7520 rate is 5.4 percent and \$10 million is contributed to the GRAT, the first annuity payment is \$9 million (90% of initial value) and the second annuity payment would be \$1,623,160. The present value of the two payments, using the 7520 rate as the discount rate, is \$10 million. If the assets decline in value to \$9 million during the first year, all the assets will be paid out on the first anniversary and can be put into a new GRAT with a \$9 million baseline. If this were a normal two year GRAT, only \$5,408,621 would be paid out on the first anniversary, leaving the rest sitting in the GRAT until the second anniversary when it can be put into another GRAT.

For example, assume the annual rates of return realized by Gary's 10-year GRAT (described above) are 3%, -7%, 8%, 6%, 10%, -2%, 15%, 12%, 9% and 8%, which yield an average return of 6.2%. As shown above, with regular two-year re-GRATs, the remaindermen would receive a total of \$2,803,800 from the GRATs, and assuming the trust receiving the GRAT remainders achieves the same returns on its investments, the remainder would have a total of \$3,329,733 at the end of 10 years, including the growth.

However, if those GRATs were decreasing GRATs, the remaindermen would receive a total of \$3,167,094 from the GRATs.

	<u>1st GRAT</u>	<u>2nd GRAT</u>	<u>3rd GRAT</u>	
Funding	\$ 10,000,000	\$	9,000,000	\$ 9,309,000
Growth - 1st year	\$ 300,000	\$	(630,000)	\$ 744,720
1st Annuity	\$ 9,000,000	\$	8,100,000	\$ 8,378,100
Amount after 1 year	\$ 1,300,000	\$	270,000	\$ 1,675,620
Growth - 2nd year	\$ (91,000)	\$	21,600	\$ 100,537
2nd Annuity	\$ 1,209,000	\$	291,600	\$ 1,511,000
Amount after 2 years/benefit of GRATs	\$ -	\$	-	\$ 265,158

<u>4th GRAT</u>	<u>5th GRAT</u>	<u>6th GRAT</u>	<u>7th GRAT</u>	<u>8th GRAT</u>	<u>9th GRAT</u>
\$ 8,669,700	\$ 9,313,730	\$ 9,789,588	\$ 10,322,396	\$ 10,190,799	\$ 10,847,209
\$ 520,182	\$ 931,373	\$ (195,792)	\$ 1,548,359	\$ 1,222,896	\$ 976,249
\$ 7,802,730	\$ 8,382,357	\$ 8,810,629	\$ 9,290,157	\$ 9,171,719	\$ 9,762,488
\$ 1,387,152	\$ 1,862,746	\$ 783,167	\$ 2,580,599	\$ 2,241,976	\$ 2,060,970
\$ 138,715	\$ (37,255)	\$ 117,475	\$ 309,672	\$ 201,778	\$ 164,878
\$ 1,407,231	\$ 1,511,767	\$ 900,642	\$ 1,675,490	\$ 1,654,130	\$ 1,760,676
\$ 118,636	\$ 313,724	\$ -	\$ 1,214,781	\$ 789,624	\$ 465,172

Assuming the trust receiving the GRAT remainders achieves the same returns on its investments, the remainder would have a total of \$3,833,366 at the end of 10 years, including the growth-- about \$500,000 (or 15%) more than regular re-GRATs.

Year	SOY		Growth		Remainder received		EOY	
1	\$	-	\$	-	\$	-	\$	-
2	\$	-	\$	-	\$	-	\$	-
3	\$	-	\$	-	\$	-	\$	-
4	\$	-	\$	-	\$	265,158	\$	265,158
5	\$	265,158	\$	26,516	\$	118,636	\$	410,309
6	\$	410,309	\$	(8,206)	\$	313,724	\$	715,827
7	\$	715,827	\$	107,374	\$	-	\$	823,201
8	\$	823,201	\$	98,784	\$	1,214,781	\$	2,136,766
9	\$	2,136,766	\$	192,309	\$	789,624	\$	3,118,699
10	\$	3,118,699	\$	249,496	\$	465,172	\$	3,833,366

The benefits are more pronounced when returns are more volatile. If the rate of return the first year is 7% and the following year is 0%, with the rest of the years repeating that pattern (7%, 0%), a single 10-year GRAT or a series of regular re-GRATs would produce ZERO benefit after 10 years. Each GRAT would start out strong but the second year's returns would not be sufficient to leave a remainder. If decreasing re-GRATs are used, the remaindermen would have \$462,846 after 10 years. The decreasing re-GRAT "captures" most of the gain achieved in the first year by distributing most of the appreciated assets to the grantor.

Are decreasing annuity payments permitted?

Regulation Section 25.2702-3(b)(1)(ii) says that the annuity payments must be a stated dollar amount payable at least annually, "but only to the extent the amount does not exceed 120 percent of the stated dollar amount payable in the preceding year." Alternatively, the annuity payments can be expressed as a fixed fraction or percentage of the initial fair market value of the trust, "but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year."

Clearly, the annuity amount can change from year to year, or there would be no need for the regulations to impose a 20% annual cap on increases. Moreover, the regulations do not prohibit or limit the amount by which annuity payments may *decrease*. The regulations do not specifically permit decreasing payments either, but they certainly could have if that was intended.

C. Disclaimer GRATs

By using a qualified disclaimer under Code Section 2518,⁵ one decide whether to fund a GRAT in hindsight. Section 2518 generally provides that if a person makes a qualified

⁵ **Sec. 2518.** (a) GENERAL RULE.—For purposes of this subtitle, if a person makes a qualified disclaimer with respect to any interest in property, this subtitle shall apply with respect to such interest as if the interest had never been transferred to such person.

(Continued...)

disclaimer, the property is treated as never having been transferred to such person for gift/estate tax purposes. Instead, the property passes pursuant to the instrument of transfer. For example, if A leaves property to B in A's will, but if B is not living it passes to B's children, if B makes a qualified disclaimer, the property will pass to B's children, and B will be treated as never having received the property (*i.e.*, no gift by B).

In the context of a GRAT, one could transfer one or more assets to a lifetime "GPA" marital trust for his or her spouse. The trust would provide that if the spouse makes a qualified disclaimer of any of the property, that property will pass to a GRAT (that has been drafted and executed but not funded). Assume the donor contributes three stocks to the marital trust and 8 months later two have appreciated and one has declined in value. The spouse could make a qualified disclaimer of the appreciated stock, causing them to be transferred to the GRAT. For gift tax purposes, the marital trust is treated as never

(b) **QUALIFIED DISCLAIMER DEFINED.**—For purposes of subsection (a), the term "qualified disclaimer" means an irrevocable and unqualified refusal by a person to accept an interest in property but only if—

- (1) such refusal is in writing,
- (2) such writing is received by the transferor of the interest, his legal representative, or the holder of the legal title to the property to which the interest relates not later than the date which is 9 months after the later of—
 - (A) the date on which the transfer creating the interest in such person is made, or
 - (B) the day on which such person attains age 21,
- (3) such person has not accepted the interest or any of its benefits, and
- (4) as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either—
 - (A) to the spouse of the decedent, or
 - (B) to a person other than the person making the disclaimer.

(c) **OTHER RULES.**—For purposes of subsection (a)—

- (1) **DISCLAIMER OF UNDIVIDED PORTION OF INTEREST.**—A disclaimer with respect to an undivided portion of an interest which meets the requirements of the preceding sentence shall be treated as a qualified disclaimer of such portion of the interest.
- (2) **POWERS.**—A power with respect to property shall be treated as an interest in such property.
- (3) **CERTAIN TRANSFERS TREATED AS DISCLAIMERS.**—A written transfer of the transferor's entire interest in the property—
 - (A) which meets the requirements similar to the requirements of paragraphs (2) and (3) of subsection (b), and
 - (B) which is to a person or persons who would have received the property had the transferor made a qualified disclaimer (within the meaning of subsection (b)), shall be treated as a qualified disclaimer.

having received the stocks, and the GRAT is treated as having received them on day one. This can provide quite an advantage with a GRAT.

D. Conclusions

Both the *amount* and *probability* of passing wealth to the next generation can be increased by using rolling GRATs, and these are increased even more when decreasing rolling GRATs are utilized. Disclaimer GRATs increase the odds even more.