Grantor Retained Annuity Trusts—Tax-Free Plan for Family Businesses

By Shelly Meerovitch

Introduction

Planning for a client with a family-owned business presents many unique challenges to the estate planner. The ultimate goal is to strike a comfortable balance between a client's need to maintain control of the family business and the client's wish to minimize transfer taxes and protect his or her successors. The use of grantor retained annuity trusts ("GRATs") has always been a popular method in achieving this resolution. Now more than ever, with interest rates at historic lows, the use of GRATs can minimize, or even eliminate, transfer taxation while permitting the client to maintain control over the family business. This article is intended to (1) present a brief overview of what GRATs are and how they operate, (2) discuss developments in the law pertaining to GRATs that every practitioner should be aware of and (3) provide a step-by-step illustration of how to use a GRAT to minimize taxation and maximize your client's control of a family business, while highlighting key considerations that should not be overlooked.

Grantor Retained Annuity Trusts—Background

What are Grantor Retained Annuity Trusts ("GRATs")?

GRATs are trusts by which, after an initial contribution of property, the grantor retains the right to receive a fixed annual amount from the trust for a fixed period (the "Distribution Period"). The Distribution Period can vary according to a number of factors discussed below. After the Distribution Period, the GRAT terminates and the remaining assets can either continue in further trust for, or be distributed to, beneficiaries other than the grantor.

Valuing the Gift to a GRAT

Generally, the value of property gratuitously transferred during a person's life is subject to a gift tax. However, where GRATs are utilized, because the grantor retains the "use" of the GRAT assets during the Distribution Period, the value of the gift to the GRAT's remaindermen (the individuals whose beneficial enjoyment of the property is deferred until the end of the Distribution Period) is not the fair market value of the assets at the time of contribution. Instead, the value of the gift to the GRAT's remaindermen is the present value of their right to receive the remaining GRAT assets at the end of the GRAT's term. In other words, the value is reduced by the present value of the grantor's right to "use" the GRAT assets during the Distribution Period. Ideally, property contributed to a GRAT will appreciate in value over the term of the GRAT sufficiently so that the value of the assets received by the beneficiaries after the Distribution Period will exceed the present value of their remainder interest calculated at the time of the transfer. Here is where the real benefit of this estate-planning tool can be realized. To the extent the assets appreciate in value during the distribution period at a rate in excess of present interest, this appreciation will not be subject to additional gift tax since the value of the gift is fixed on the date of the GRAT's creation.

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Thus, the initial valuation of the remainder interest in the GRAT is critical to the GRAT's success. The value of the remainder interest is determined at the time of contribution according to the valuation principals set forth in § 7520 of the Internal Revenue Code[1]. The following three variables must be considered in valuing the remainder interest: the length of the Distribution Period, the § 7520 rate applicable in the month when the GRAT is created and the size of the guaranteed annuity that will be paid to the grantor.

The longer the term of the GRAT, the lower the § 7520 rate and the higher the retained annuity, the greater the reduction in the value of the gift. Consequently, the current historically low interest rates make GRATs a particularly attractive estate-planning tool.

Estate Taxation of a GRAT

If the grantor dies before the end of the GRAT term, some or all of the GRAT corpus will be included in the grantor's estate. Until recently, the Internal Revenue Service (the "IRS") has taken the position that, if the grantor dies before the end of the GRAT term, the entire trust corpus will be included in the grantor's estate under § 2039. However, in 2007, the IRS issued proposed regulations that would instead apply § 2036 to GRATs, providing that the portion of the GRAT includible in the decedent's estate would only be the portion of the trust corpus necessary to yield the annual payments applying the appropriate § 7520 rate.[2]

Whether the IRS applies § 2039 or § 2036, it is advisable to use a GRAT term that the grantor can be reasonably expected to survive. Usually, the GRAT will continue until the end of the term, paying the annuity to the grantor's estate if he dies before the end. Upon the expiration of the GRAT term, the property then on hand will be distributed in accordance with the provisions of the GRAT.

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Zeroing Out the Gift to a GRAT

A zeroed-out GRAT is a GRAT in which the grantor retains an interest (i.e., annuity stream) that is equal in value to the value of the property contributed to the GRAT. This results in a taxable gift to the GRAT's remaindermen having a value of zero and consequently, upon the creation of the GRAT (or initial transfer of property), no gift tax will be due or Applicable Exemption Amount used. The IRS formerly took the position that it was never possible to zero-out a GRAT[3] in light of the possibility that the grantor will predecease the term of the GRAT. The IRS' position was that the continuing payments to the grantor's estate did not constitute the retention of a "qualified interest" under § 2702. Thus, the IRS ignored the continuing payments to the grantor's estate, reasoning that a grantor's right to receive an annuity for the shorter of his life or a fixed term was always going to be worth less than the grantor's right to receive the annuity for a fixed term.

However, in 2000, in *Walton v. Comr.*, 115 T.C. 589, the Tax Court formally rejected the IRS position. In *Walton*, the Court held that it is indeed possible to zero-out a GRAT because the annuity payments to the grantor's estate may be considered in determining the value of the retained interest in the case of a GRAT. Since *Walton*, the IRS has acquiesced to the Tax Court's position.[4]

Income Taxation of a GRAT

From an income tax perspective, the GRAT is a grantor trust and its income, including capital gains, is taxed to the grantor, whether or not it exceeds the annuity amount. The terms of the GRAT may authorize reimbursing the grantor for such tax payments.[5] If the grantor survives the GRAT term, there will be no further tax to the grantor on any continuing trust income unless the grantor's spouse is a beneficiary of the continuing trust or it is deliberately drafted to "flunk" the grantor trust rules.[6] In such case, the income of the trust will continue to be taxed to the grantor.

Use of GRATs to Plan for the Disposition of a Family Business—An Illustration

Generally

As a result of the *Walton* decision and the current historically low interest rates, the climate has never been better for GRATs to be incorporated in the estate plans of clients with income-producing family-owned businesses. As long as the family business has sufficient cash flow, zeroed-out GRATs can be utilized to eliminate the estate taxes on the value of the business at no tax cost, while allowing for the maintenance of voting control over the company.

The following is a brief illustration of the steps that could be taken to accomplish this goal. Assume a Husband and Wife each own 50% of a closely held family business ("Fam Co"). Assume further that Fam Co constitutes the lion's share of the value of Husband's and Wife's estates.

Step 1: An independent appraiser should appraise the value of Fam Co.

Step 2: Assuming Fam Co has 100 outstanding shares, Fam Co should then be re-capitalized so that each of Husband and Wife will own one voting share and 49 non-voting shares.

Step 3: Each of Husband and Wife should then create his/her own GRAT and contribute his or her non-voting shares to it. The term of the GRAT and the annuity payments will depend on the appraised value assigned to the spouses' respective interests in Fam Co. The value should be further discounted to reflect the fact that the contributed interests are minority non-voting interests in a privately held company. Note that during the term of the GRAT, Husband and Wife may continue to act as trustees of their respective GRATs. During the term of the GRATs, each of the grantors will receive a fixed annuity payment generated by the income earned by the Fam Co shares contributed to the GRAT. To the extent the income earned by Fam Co is insufficient to satisfy the annuity obligation in full, a loan arrangement can be entered into to leverage the Fam Co shares. It should be noted, however, that if access to the GRATs' property beyond the required annuity payments is desired (for

example, to reimburse the grantor(s) for income taxes on the GRAT's income if it exceeds the annuity payment), an unrelated disinterested trustee who does not have a beneficial interest in the GRAT will need to be appointed.

Step 4: Since the remainder interests (if in further trust) in the two GRATs must differ if the reciprocal trust doctrine is to be avoided, upon the expiration of the term of the GRATs, it is recommended that (a) Wife become the sole beneficiary of the continuing trust under Husband's GRAT, and (b) Husband and children become the beneficiaries of the continuing trust under Wife's GRAT, or vice versa.

Step 5: Additional flexibility can be built in by giving each of Husband and Wife, upon their respective deaths, a limited power over the trust created by his or her spouse to modify the duration, etc., of the continuing trusts for the children. This option allows each spouse to make determinations in the future while ensuring that the children's beneficial interests are protected.

Income Taxation—Additional Planning Opportunity

As discussed above, each of Husband and Wife will be responsible for paying the income taxes on the income generated by their respective GRATs. While some states[7] allow for reimbursement from the GRATs for such payments, estate planners should make their clients aware of the benefits of not being reimbursed. First, if the grantor is not reimbursed by the GRAT for the grantor's payment of income taxes, the GRAT is effectively augmented by the grantor, to the extent of the value of the income taxes, without the grantor having to pay any gift taxes. Second, by paying the GRAT's income taxes the grantor is able to further reduce his or her estate for estate tax purposes.

Estate planners should pay careful attention when drafting the provision authorizing the grantor's reimbursement. In Revenue Ruling 2004-64 the IRS concluded that while a grantor's payment of income taxes generated by a grantor trust will not result in the grantor making an additional taxable gift to the trust, if the reimbursement of the grantor is mandated either by the trust agreement or by State law, all of the trust assets will be included in the grantor's taxable estate. If, however, the trustee only has the *discretion* to reimburse the grantor, the existence of such discretion in and of itself should not cause the trust assets to be includible in the grantor's gross estate. In the latter case, the presence of other facts, such as a pre-existing understanding or arrangement between the grantor and the trustee with respect to reimbursement may result in inclusion of the trust assets in the grantor's estate.

Thus, in order to ensure that the trust assets are not subject to estate tax in the grantor's estate, reimbursement provisions should be discretionary and, where State law makes reimbursement mandatory, the trust agreement should specifically opt out of such State law.

Estate Taxation—Providing for Death Before Expiration of GRAT Term

One Spouse Predeceases the GRAT Term—If either Husband or Wife does not survive the term of his or her GRAT, the interest in Fam Co will either revert to his or her estate or be disposed of pursuant to a retained power of appointment. To ensure that no estate taxes will be generated until the surviving spouse dies under such circumstances, Husband and Wife should consider leaving their residuary estate, or at least their contingent reversion in the GRAT, to the survivor. If this is done, no estate taxes will be generated because the gift will qualify for a marital deduction. Finally, the surviving spouse will have the opportunity to create another GRAT with the property she or he inherits, effectively creating a "second bite at the apple" to continue the estate planning begun by the grantor.

Both Spouses Predecease the GRAT Terms—Clients should be advised of the option of obtaining a term joint and survivor insurance policy to provide the survivor's estate with the liquidity needed to pay for the estate taxes that will be due should both of them predecease the term of their respective GRATs. Such a policy should be relatively inexpensive, as it is both a term and a joint survivor policy (meaning it has no cash surrender value and only pays out if both of the clients die). In order to ensure that the proceeds of this policy are not themselves included in the clients' estate for estate tax purposes, it is recommended that the trustees of an Insurance Trust purchase this insurance policy.

Effect of Creating Lifetime GRATs on Testamentary Plans

Where Fam Co comprises the majority of the clients' estates, if Husband and Wife survive the terms of their respective GRATs a substantial portion of their estates will be disposed of by the terms of the GRATs. Under such circumstances, additional tax planning can further reduce or even eliminate the estate tax that will become due on the couple's remaining assets (including the remaining voting shares in Fam Co not initially transferred to the GRATs) upon their death.

This can be achieved through the creation of a testamentary Charitable Lead Trust ("CLT") that will be funded with the surviving spouse's Fam Co voting shares and any of his or her remaining assets which are not specifically bequeathed. This will further reduce

any estate taxes due on the survivor's death through the use of a charitable deduction. The charity named could be the Husband's and Wife's own family foundation and their children can act as the directors of the foundation. During the term of the CLT, an annuity or a unitrust amount will be paid to the charity of the Husband's and Wife's choosing and upon the expiration of a given term of years, the CLT's property will be distributed to the children.

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Conclusion

A good estate plan is one that not only minimizes transfer taxation but also successfully addresses a client's concerns about control and family needs. Striking a balance among these often-competing objectives is always a delicate task but when a client's estate is largely comprised of a family-owned business, the planning process becomes even more challenging. In light of recent developments in the law and with interest rates at historic lows, GRATs are now particularly useful in planning for estates with income producing family-owned businesses because they can enable clients to maintain control over their family-owned businesses while still minimizing transfer taxation.

Endnotes

1. Section 7520 of the Internal Revenue Code of 1986, as amended (hereafter IRC); Treas. Regs. § 20.7520-3(b) and § 25.7520-3(b).
2. Prop. Regs. § 20.2036-1(c)(2)(i).
3. Treas. Regs. § 25.2702-3(e) *Ex.* 5.
4. Notice 2003-72 and 2003-44 I.R.B.
5. Rev. Rul. 2004-64, 2004-27 I.R.B. 7.
6. *E.g.*, by giving the grantor the ability to substitute trust property under § 675(4) of the Code.
7. *See, e.g.*, New York Estate Powers and Trusts Law 7-1.11(a).

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