THE CARE AND FEEDING OF GRATs – ENHANCING GRAT PERFORMANCE THROUGH CAREFUL STRUCTURING, INVESTING AND MONITORING

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I. <u>INTRODUCTION</u>

The Grantor Retained Annuity Trust (the "GRAT") is one of the most powerful, currently available estate planning technique. A GRAT enables a grantor to transfer, free of gift tax, that portion of a transferred asset's future investment return that exceeds the rate of return § 7520[1] requires the Internal Revenue Service ("IRS") to use to value annuity interests. Unlike outright gifts or sales or installment sales to grantor trusts, the GRAT delivers its benefits without any potential transfer tax disadvantage to the grantor or her family and the trusts she has created for them.[2]

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[1] References to "§" and "section" in this outline, unless otherwise indicated, refer to sections of the Internal Revenue Code of 1986, as amended (the "Code"). References to "Treas. Reg. §" refer to sections of the regulations promulgated by the Treasury under the Code. References to the "IRS" are to the Internal Revenue Service.

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[2] The Obama administration recognizes that the GRAT is an efficient tool for transferring wealth. Although there are many approaches it could have chosen to reduce its efficiency, the five changes it has proposed this year, each of which is described below, would substantially eliminate the GRAT as an effective planning device.

This outline explains how the GRAT technique works and discusses ways to enhance its performance by carefully structuring its provisions, selecting its investments and monitoring its performance. It also compares the effectiveness of the GRAT with three other competing techniques – the gift, the sale, and the preferred interest freeze.

II. <u>DEFINING THE GRAT</u>

A. <u>In General</u>

A GRAT is a trust that pays an annuity to its grantor for a specified period of time. At the end of the period, the beneficial interest in the trust shifts to another beneficiary or beneficiaries.

If the terms of the trust instrument satisfy the governing instrument requirements set forth in Treas. Reg. § 25.2702-3, the grantor's interest is a "qualified annuity interest" and the value of the gift to the remainder beneficiaries is determined under § 7520.[3]

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(1) GRATs must have a minimum term of 10 years.

(2) GRATs may not provide for declining annuity payments.

(3) GRATs may last no longer than the life expectancy of the annuitant plus 10 years.

(4) The initial value of the remainder interest must be equal to 25% of the value of the assets contributed to the GRAT or $500,000, if greater.

(5) The grantor may not engage in a tax-free exchange of assets held in the GRAT.

General Explanation of the Administration's Fiscal Year 2016 Revenue Proposals, Department of the Treasury 2015, p. 197.

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[3] §2702(a)(2)(B). If a grantor's retained interest in a trust for the benefit of members of her family is not a qualified interest and does not fit within one of the exceptions to the general rule of §2702, the value of her transfer for gift tax purposes is equal to the full value of the property transferred to the trust. For this purpose, the members of a grantor's family are her spouse, her ancestors and descendants, her siblings and the spouses of her ancestors, descendants and siblings.

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The Code permits the value of the gift to the remainder beneficiaries to be determined under § 7520 because the required structure of the GRAT seems to prevent the trustee from manipulating investment decisions for the purpose of shifting economic enjoyment between the trust's annuity and remainder beneficiaries. The annuitant is entitled to receive the annuity no matter what the trust's income is. As a result, a trustee whose object is to maximize the interest of the trust's remainder beneficiaries would have no incentive to maximize growth opportunities at the expense of current income.[4] So long as the total return, whether income or appreciation, is consistent with the § 7520 rate, a GRAT's annuitant and its remainder beneficiaries will receive their appropriate share of trust assets.

B. Governing Instrument Requirements

There are eight governing instrument requirements for a GRAT's trust instrument, each of which is described briefly below. Although the regulations require only that these provisions be included in the governing instrument, the IRS often takes the position on audit that a GRAT does not provide a qualified annuity payment if there has been an actual failure to comply with one of the required provisions of a GRAT's governing instrument.[5]

1. Frequency of Annuity Payments

An annuity amount must be payable at least once in every twelve-month period to the holder of the annuity or the annuitant. The trust instrument must require pro-ration of the annuity payment made for a period of less than 12 months in the same

[4] The trustee might, however, have an incentive to maximize the possibility of a higher overall return by making speculative investments. If the GRAT is structured initially with a zero or relatively small remainder interest, the risk burden will be borne entirely or almost entirely by the annuitant while the remainder beneficiary will enjoy the rewards but not the risks of a successful speculative investment.

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[5] The Tax Court and the 11th Circuit has agreed with this approach in the context of a charitable remainder trust. *Atkinson v. Commissioner*, 309 F.3d 1290 (11th Cir. 2002), *aff'g* 115 T.C. 26 (2000).

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manner as is required for charitable remainder annuity trusts under Treas. Reg. § 1.664-2(a)(1)(iv). The annuity must be paid to the annuitant whether or not the trust has produced income equal to the annuity. If income is insufficient, the trustee must be required to invade principal to pay the annuity.

The regulations require that the annuity must be paid no later than 105 days after the anniversary date of the creation of the trust if the annuity is payable based on the anniversary date and no later than the date on which the trustee must file the trust's income tax return (determined without extensions) if the annuity amount is payable based on the taxable year of the trust.[6]

The regulatory permission to make late annuity payments means only that the IRS will not argue that a GRAT does not create a qualified annuity interest merely because of the lateness of the payment. It does not alter the grantor's rights under the GRAT instrument. If the GRAT's instrument requires timely payment, a grantor's failure to enforce her right to be paid on time could be treated a gift loan within the meaning of § 7872(f)(3).[7] As a consequence, the grantor would be treated as having transferred an amount equal to the forgone interest to the GRAT and the GRAT, as having transferred such amount back to the grantor as interest. The foregone interest is the amount of interest that would have been payable on the amount of the annuity payment if it had been loaned to the GRAT by the grantor for the period the annuity remained unpaid after its payment date and if interest had accrued on the loan at the applicable Federal short term rate. For example, if an annuity payment of $1 million was due on January 1,

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[6] Treas. Reg. § 25.2702-3(b)(4).

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[7] The proposed regulations under § 7872 construe the term "loan" broadly to include "generally any extension of credit including, for example, a purchase money mortgage) and any transaction under which the owner of money permits another person to use the money for a period of time after which the money is to be transferred to the owner or applied according to an express or implied agreement with the owner. The term "loan" is interpreted broadly to implement the anti-abuse intent of the statute." Prop. Treas. Reg. § 1.7872-2.

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remained unpaid until April 1, and if the Federal short term rate in effect in the months of January through March was 2%, the amount of the deemed transfers back and forth between the grantor and the GRAT would be $5,000. The deemed transfer to the GRAT would be treated as a gift for gift tax purposes. Presumably, the regulatory sanction given to late payments would be sufficient to preclude the IRS from treating such a gift as an addition to the GRAT, which, as described below, are prohibited. The deemed transfer from the GRAT to the grantor would be treated as interest income. So long as the GRAT is treated as a grantor trust, wholly owned by the grantor, the interest payment should be ignored for income tax purposes.[8]

If the terms of the GRAT instrument specifically permit late annuity payments, the stream of annuity payments will have a lower value than they would have if timely payment had been required. For example, an annuity stream of $100,000 payments payable at the end of each of five years has a present value of $421,236 if the § 7520 rate is 6%. If the payments can be made 105 days after the end of the next five years, the value of the stream of payments declines to $414,234.

In order to protect against the IRS arguing that a GRAT does not provide a qualified annuity interest because one or more annuity payments have not been timely made, consideration should be given to including a provision in the trust instrument that causes the trust to terminate to the extent of the required payment if it has not actually been made within a short period of time after the payment date. A clause similar to the following could be used:

> If any portion of an Annuity Payment has not been paid to the Settlor within one hundred five (105) days after the date such payment is required to be made (the "Relevant Annuity Payment Date"), a fractional portion of the Trust from which such Annuity Payment was required to have been made shall terminate and shall vest absolutely in the Settlor, or the Settlor's estate if the Settlor dies during the Trust Term. The fraction to be used to determine the portion of the Trust that terminates shall have a numerator

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[8] See discussion at III. B. 1.

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equal to the amount of the Annuity Payment, and a denominator equal to the fair market value of the Trust Fund as finally determined for federal gift tax purposes on the Relevant Annuity Payment Date. Such fractional portion shall hereinafter be referred to as the "Terminated Portion." The Trustees shall have no further duties, power, authority or discretion to administer the Terminated Portion, notwithstanding any provision of this Trust Agreement or applicable law to the contrary. If the Terminated Portion shall remain in the hands of the Trustees after the Relevant Annuity Payment Date, the Trustees shall hold the property exclusively as nominees and agents for the Settlor or the Settlor's estate. The Settlor authorizes the Trustees, but only as nominees and agents for the Settlor or the Settlor's estate to invest the Terminated Portion on behalf of the Settlor or the Settlor's estate with the same authority as the Settlor or the Settlor's Personal Representatives could individually. The Trustees, both as trustees and as such nominees and agents, are hereby relieved of any liability for commingling assets that have vested absolutely in the Settlor or the Settlor's estate, with assets that remain part of the Trust Fund.

2. <u>Prohibition Against Use of Notes to Fund Annuity Payments</u>

The regulations state that the "[i]ssuance of a note, other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount."[9] This statement is reflected in the governing instrument requirement, appearing later in the regulations, that the GRAT instrument "must prohibit the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity . . . payment obligation."[10]

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[9] Treas. Reg.§ 25.270§ -3(b)(1)(i).

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[10] Treas. Reg. § 25.2702-3(d)(5).

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The prohibition against the "issuance" of a note or similar financial arrangement does not prevent the use of notes issued by other persons to satisfy the payment obligation. For example, a note issued by the grantor's spouse, by another trust, or even by the grantor would not violate this prohibition. The trustees of the GRAT might acquire such a note by selling some or all of the GRAT's assets to the issuer of the note. The explanatory material that preceded the final regulation in the Federal Register makes it clear that borrowing from a third party to raise funds to pay the annuity amount will be permitted but that the step transaction doctrine will be applied if a series of transactions is used to achieve the same economic result as a borrowing from the grantor. For example, a borrowing by the GRAT from a bank to pay the annuity followed by a borrowing from the grantor to repay the bank would not be permitted. The use of the phrase "directly or indirectly" in the final regulations is intended to convey this idea.[11]

The prohibition against issuing a note to satisfy an annuity payment obligation is not a prohibition against grantor loans to the GRAT for other purposes, including providing it with funds to make investments or to pay expenses. Because money is fungible, care should be taken to segregate funds loaned to the GRAT by the grantor for investment purposes or for the purpose of paying expenses from other funds in order to prevent the IRS from taking the position that funds loaned to the GRAT by the grantor were used to make an annuity payment.

3. <u>Fixed Amount Requirement</u>

The annuity amount must be a fixed amount. By this the regulations mean an amount that is fixed in the trust instrument as a fixed dollar amount or as a fixed percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes.[12] The regulations do not require that the

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[11] 65 Fed. Reg. 53587 (September 5, 2000).

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[12] Treas. Reg. § 25.2702-3(b)(1)(ii). The IRS will not ordinarily issue rulings on whether annuity interests are qualified annuity interests under § 2702 if the amount of the annuity payable annually is greater than 50% of the initial net fair market value of the property transferred to the trust, or if the value of the remainder interest is less than 10% of the initial net fair market value transferred to the trust. Rev. Proc.

fixed amount be the same for each year. However, any portion of a required annuity payment that exceeds 120% of the amount payable in the immediately prior year will not be treated as a qualified annuity interest. This means that its excess value will not reduce the size of the taxable gift made to the GRAT.

4. Formula Adjustment Requirement

The regulations permit the annuity amount to be defined as a fixed percentage of or as a fraction of the value of the trust's assets as finally determined for gift tax purposes. If the formula approach is used, the trust instrument must contain a provision requiring adjustment of annuity amounts previously paid if an error was made by the trustee in determining the value. The adjustment clause must satisfy the requirements of Treas. Reg. § 1.664-2(a)(1)(iii), which deals with a similar problem in connection with charitable remainder annuity trusts.[13]

5. Additions

The trust instrument must prohibit additional contributions to the trust.[14]

6. Commutation

The trust instrument must prohibit "commutation."[15] By this term, the regulations refer to the pre-payment by the trustee of the annuitant's annuity interest.

2015-3, 2015-1, I.R.B. 129, Section 4.01 (53).

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[13] Treas. Reg. § 25.2702-3(b)(2).

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[14] Treas. Reg. § 25.2702-3(b)(4).

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[15] Treas. Reg. § 25.2702-3(d)(4). *See* PLR 9412036 (December 23, 1993) in which the IRS determined that the absence of a provision prohibiting commutation would preclude treatment of an interest as a qualified interest.

7. Amounts Payable to Other Persons

The trust instrument must prohibit payments from the trust before the expiration of the qualified interest to or for the benefit of any person other than the annuitant.[16] The charitable lead trust regulations contain a similar provision.[17]

8. Term of the Annuity

The term of the qualified annuity interest must be fixed in the trust instrument and must be for (i) the life of the annuitant, (ii) a specified term of years, or (iii) the shorter of those two periods.[18] The regulations under § 2702 make it clear that the full value of an annuity interest retained for a term of years is a qualified interest even if some of the annuity payments may be made after the grantor's death.[19]

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[16] Treas. Reg. § 25.2702-3(d)(2).

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[17] Treas. Reg. § 25.2522(c)-3(c)(2)(vi)(f).

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[18] Treas. Reg. § 25.2702-3(d)(3).

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[19] 70 F.R. 9222-9224 (February 25, 2005). Example 5 of Treas. Reg. §25.2702-3(e) originally provided that only the portion of an annuity payable during the life of the annuitant is a qualified interest even though the annuity is actually payable for a term of years and any payments made after the annuitant's death are required to be paid to her estate. In December 2000 a unanimous Tax Court held in *Walton v. Commissioner* that the original Example 5 was invalid. *Walton v. Commissioner*, 115 T.C. 589 (2000). The Tax Court concluded in *Walton* that Congress intended to permit a grantor to retain qualified annuity interests for a specified term of years, that the appropriate method for doing so is to provide that the balance of any payments due after the grantor's death should be payable to her estate, and that Example 5 is an unreasonable and an invalid extension of §2702.

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III. THE TAX CONSEQUENCES OF CREATING, FUNDING, ADMINISTERING AND TERMINATING A GRAT

A. Creating and Funding

1. Gift Tax Issues

The value of a grantor's transfer to a GRAT for gift tax purposes is determined by subtracting from the value of the property transferred to the GRAT an amount equal to the actuarial value, determined under the tables prescribed by the Treasury pursuant to § 7520, of the grantor's retained annuity interest.[20] The tables use an interest rate equal to 120% of the federal mid-term rate in effect under § 1274 on the date of the gift. The interest rate is changed monthly.

In the case of an annuity payable for a fixed period of years, the actuarial value of the annuity is determined by four factors – (1) the period of time over which the annuity is payable, (2) the frequency of the payments, (3) the size of each of the payments and (3) the § 7520 rate in effect in the month that the GRAT is created and funded. If the first three factors are held constant, the value of the retained annuity will increase with decreases in the § 7520 rate. This is so because a decrease in the deemed rate of current return will tend to make the right to receive fixed amounts in the future more valuable.

The table below shows how changes in the § 7520 rate will affect the amount of annuity payment necessary to produce an annuity with a value equal to the value of the transferred property if the payments are constant and are made annually over a 2, 5, 10, 15 or 20 year period.

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[20] §2702(a)(2)(B).

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Table 1

§ 7520 Rate	Annuity as % of Value of Transferred Property				
	2-Year GRAT	5-Year GRAT	10-Year GRAT	15-Year GRAT	20-Year GRAT
2.00%	51.51%	21.22%	11.13%	7.78%	6.12%
3.00%	52.26%	21.84%	11.72%	8.38%	6.72%
4.00%	53.02%	22.46%	12.33%	8.99%	7.36%
5.00%	53.78%	23.10%	12.95%	9.63%	8.02%
6.00%	54.54%	23.74%	13.59%	10.30%	8.72%
7.00%	55.31%	24.39%	14.24%	10.98%	9.44%
8.00%	56.08%	25.05%	14.90%	11.68%	10.19%
9.00%	56.85%	25.71%	15.58%	12.41%	10.95%
10.00%	50.75%	26.38%	16.27%	13.15%	11.75%

2. **Income Tax Issues**

A GRAT is likely to be a so-called grantor trust because the retained annuity interest is almost always worth more than 5% of the value of the trust at its inception.[21]

As a result, the grantor will not recognize gain when she funds the GRAT with appreciated assets even if she transfers property to the trust that is subject to debt in excess of basis, such as partnership interests with negative bases.[22]

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[21] § 673.

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[22] PLR 9416009 (December 30, 1993); PLR 9230021 (April 28, 1992).

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B. Administering

1. Income Tax Issues

Because the GRAT is a grantor trust, the grantor will not be taxed on the distributions she receives from the trust. Instead, she will be taxed on all of the trust's income whether or not it is distributed to her and all of the trust's deductions and credits will be treated as belonging to her. In addition, transactions between the trust and its grantor are generally ignored for all income tax purposes.

There are at least three significant benefits to a GRAT and its grantor that flow from grantor trust status:

(1) No gain or loss is recognized when the trust either sells an asset to or buys an asset from its grantor.[23] This principle permits a GRAT to use appreciated trust assets to satisfy its annuity obligation without recognizing gain.[24] A 2007 revenue ruling confirmed that the no gain or loss result applies to sales between trusts that are treated under the grantor trust rules as owned by the same grantor.[25]

[23] Rev. Rul. 85-13, 1985-1 C.B. 184. *But see Rothstein v. United States*, 735 F.2d 704, 84-1 U.S.T.C. ¶ 9505 (2d Cir. 1984), in which the Second Circuit took a contrary position.

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[24] *E.g.*, PLR 9736029 (June 8, 1997); PLR 9736028 (June 9, 1997); PLR 9735034 (June 2, 1997); PLR 9625021 (March 20, 1996); PLR 9352017 (September 30, 1993); PLR 9352007 (September 28, 1993); PLR 9351005 (September 16, 1993); PLR 9239015 (June 25, 1992). In the absence of the grantor trust rules, a distribution of property other than cash to satisfy an annuity obligation of the GRAT would be a recognition event. *Kenan v. Commissioner,* 114 F.2d 217 (2d Cir. 1940); *Suisman v. Eaton,* 115 F.Supp. 113 (D. Conn. 1953) *aff'd per curiam*, 83 F.2d 1019 (2d Cir. 1936), *cert. denied*, 299 U.S. 573 (1936).

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[25] Rev. Rul. 2007-13, 2007-1 C. B. 684

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(2) A grantor may make an interest-bearing loan to a GRAT without being required to include the interest in her gross income.[26]

(3) The trust will be permitted to hold shares in an S Corporation.[27]

Until 2004, the IRS refused to give taxpayers the assurance that their payment of income taxes on the income earned by trusts treated as owned by them under § 671 would not be treated as taxable gifts. This changed with the issuance of Rev. Rul. 2004-64.[28]

In Rev. Rul. 2004-64, the IRS ruled that the grantor of a trust who is treated as the owner of the trust and who pays the income tax attributable to the inclusion of the trust's income in her taxable income is not treated as making a gift of the amount of the tax to the trust beneficiaries. Additionally, it ruled that if the trust's governing instrument or applicable local law, requires the trustee to reimburse the grantor for the income tax payable by the grantor that is attributable to the trust's income, the full value of the trust's assets will be includible in the grantor's gross estate under Code § 2036(a)(1).

2. <u>Modifying the Governing Instrument During the Annuity Term</u>

The regulations do not impose any adverse consequences if the parties, the trustee and the beneficiaries or the grantor or beneficiaries, subsequently decide to disregard a requirement contained in the trust instrument. For example, as discussed

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[26] PLR 9510929 (February 10, 1995).

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[27] § 1361(c)(2)(A)(i). *See* PLR 9352004 (September 24, 1993).

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[28] 2004-2 C. B. 7.

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above, the regulations require that the trust instrument prohibit prepayment of the annuity. In many states, the creator of a trust, with the consent of all of the beneficiaries, may revoke or amend the terms of a trust.[29] What would the consequences be under § 2702 if a trust that otherwise qualified as a GRAT were subsequently amended to provide a commutation clause?

If the statute of limitations on the collection of gift taxes for the year in which the GRAT was created is still open, the IRS might take the position that the annuity interest was not a qualified interest.

The IRS might also take the position that an amendment is a new transfer and, if the trust immediately after the amendment does not satisfy the regulations' requirements, subject the full value of the trust to gift tax. An amendment, however, that resulted in the simultaneous termination of the trust would probably not be vulnerable to a new application of § 2702 because, immediately after the amendment, neither the transferor nor any other family member would have an interest in the trust.

C. <u>Terminating</u>

If there is property left in the GRAT to be paid to the GRAT's remainder beneficiaries when the GRAT ends, the property will pass to them free of gift tax. This will be so even if the creation of the GRAT was not treated as a taxable gift by the grantor because the value of the retained interest was treated as equal to the value of the property transferred. The transfer tax system does not permit the IRS to make any post-transfer adjustments in the value of transferred property to reflect the fact that its investment performance was significantly better than the assumed performance on which the original valuation was based.

No income tax will be imposed on the GRAT or its grantor when appreciated property is distributed to the GRAT remainder beneficiaries at the end of the GRAT. The basis of the distributed property, however, will be a carryover basis under §

[29] *See, e.g.*, Cal. Prob. Code § 15404; Fla. Stat. § 737.4032; and NY EPTL § 7-1.9.

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1015. If the distributed property is sold after the grantor's death or if it is sold by a remainder beneficiary that is not a grantor trust treated as owned by the grantor, the income tax imposed on the gain can significantly reduce the amounts that the remainder beneficiary retains.

> **Example 1:** G creates a 5-year GRAT and transfers $1 million worth of X stock with a zero basis to the GRAT. G retains the right to receive an annuity equal to $234,700 per year for 5 years. Because the value of the right to receive $234,700 per year, assuming a §7520 rate of 5.6%, is worth $999,493, her creation of the GRAT will have resulted in a taxable gift of $507. During the 5-year term of the GRAT, the shares of X grow in value by 10% per year. At the end of the GRAT term, the remainder beneficiary will receive X shares worth about $177,643. When these shares are sold, unless the remainder beneficiary is a grantor trust, treated as wholly owned by the grantor, the beneficiary will pay a tax on its gain of $35,528 (assuming a 20% tax rate on long term capital gains) and a 3.8% Medicare tax, leaving it with only $140,764.

The tax on disposition issue can become more significant if the GRAT borrows funds to make the annuity payments to the grantor. Consider the following example:

> **Example 2:** The trustees of the GRAT described in Example 1 borrowed to make all of the annuity payments to G. The loans carried an interest rate of 4.5%. At the end of the GRAT term, the remainder beneficiary received X stock worth $1,610,510, subject to a debt, including accrued interest, of $1,283,976. If the remainder beneficiary of the GRAT is not a grantor trust treated as owned by G, the termination of the GRAT will be a recognition event for G. She will be treated as having an amount realized equal to the amount of the debt.[30] If the remainder beneficiary is a grantor trust but sells the X stock after G's death, it will pay income tax on the gain.

[30] Treas. Reg. §1.1001-2(a); *See* TAM 200020020, 200010011, and 200011005 (November 29, 1999).

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IV. STRUCTURING THE SUCCESSFUL GRAT

A. Creating GRATs With No Taxable Gifts

Creating a GRAT that produces anything other than a nominal taxable gift is generally tax inefficient. The ability to structure GRATs that shift the economic advantage of the transferred property's investment return from the grantor to the GRAT's remainder beneficiaries without creating a taxable gift is one of the reasons to use the GRAT rather than an alternate estate planning technique. A GRAT will produce a zero taxable gift if the actuarial value of the retained annuity payments is equal to the value of the property transferred to the GRAT. A GRAT that is created without a taxable gift is generally referred to as a "zeroed-out" GRAT.

When a grantor incurs a taxable gift as a result of her transfer to a GRAT, there is a possibility that reverse leverage will produce a negative transfer tax result. If the transferred property fails to produce a rate of return equal to the § 7520 rate, the gifted portion of the transferred property will be used to pay the required annuity to the grantor.

Consider this example:

> **Example 3:** G creates a 10-year GRAT and transfers $1 million worth of stock in the X corporation to it in a month in which the § 7520 rate is 2%. G retains the right to receive an annuity equal to $55,650 per year for 10 years. This transfer will create a taxable gift of $500,000 because the right to receive $55,650 per year for 10 years has an actuarial value of $500,000. The stock declines in value over the 10 year term. The annuity payments are made by distributing stock to G. The remainder beneficiary receives nothing. The grantor has either wasted $500,000 of her unified credit, protecting a gift from gift tax that resulted in no economic benefit to the donee, or has paid a gift tax on a gift that resulted in no economic benefit to the donee.

If the grantor had limited her transfer to the GRAT to $500,000 worth of the stock and had made an outright gift of the other $500,000 worth of stock, at the end of the 10-year period, the donee would have been left with one-half of the stock. Her unified credit or her payment of gift tax would not have been completely wasted.

B. Period of Time Over Which Annuity is Payable

1. Reasons to Choose a Short-Term GRAT

The 2-year term offers two advantages over a longer term.[31] First, it minimizes the possibility that a year or two of poor performance of the transferred property will adversely impact the over-all effectiveness of the GRAT. When a GRAT is funded with a volatile security, a series of short-term GRATs will generally perform better than a single long-term GRAT, the term of which is equivalent to the cumulative terms of the short-term GRATs. Tables 2 and 3 below compare the results of a 9 year GRAT with the results of a series of three 3-year GRATs, each of which was funded and each of which was structured to produce a zero taxable gift. Both tables assume a rate of return on the GRAT's stock consistent with the performance of the NASDAQ from September 2001 to September 2010. The tables show that the series of short-term GRATs leave the remainder beneficiary with significantly more value than does the long-term GRAT, $539,693 v. $0.

[31] An even shorter term would be more advantageous. But in setting the trust's term, care must be taken to avoid an argument that a trust's term is so short that it will not be recognized for tax purposes. In addition, it might be possible to interpret § 2702(b)(1) as requiring a period of at least two years, because the section defines a qualified interest as "the right to receive fixed amounts payable not less frequently than annually." Private letter rulings have recognized the validity of 2-year GRATs. *See, e.g.*, PLR 9239015 (June 25, 1992).

$P = \frac{A}{i}$ $P = \frac{A}{i}$

Table 2

Long-Term GRAT

	Year	Value of GRAT Property Beginning of Year	% Increase of Decrease	Increase or Decrease	Annuity Payment 7520 Rate 5.8%
1	9/1/2001	$ 1,000,000	-22%	$ (218,001)	$ 145,745
2	9/1/2002	$ 636,254	52%	$ 333,788	$ 145,745
3	9/1/2003	$ 824,297	6%	$ 50,696	$ 145,745
4	8/31/2004	$ 729.247	13%	$ 97,978	$ 145,745
5	9/1/2005	$ 681.480	5%	$ 33,807	$ 145,745
6	9/1/2006	$ 569.542	20%	$ 111,736	$ 145,745
7	9/1/2007	$ 535.532	-23%	$ (120,848)	$ 145,745
8	8/31/2008	$ 268.939	1%	$ 3,926	$ 145,745
9	9/1/2009	$ 127,120	12%	$ 28,686	$ 98,434
	9/1/2010	$0			

Table 3

Series of Short-Term GRATs

	Year	Value of GRAT Property Beginning of Year	% Increase or Decrease	Amount of Increase or Decrease	Annuity Payment 7520	Grantor Has	Remainder Beneficiary Has
					5.80%		
1	9/1/2001	$ 1,000,000	-22%	$ (218,001)	$ 372,726	$ 372,726	
2	9/1/2002	409,272	52%	214,710	372,726	940,990	
3	9/1/2003	251,257	6%	15,452	266,710	1,265,572	0
					4.80%		
4	9/1/2004	1,256,572	13%	170,036	365,833	365,833	
5	9/1/2005	1,069,775	5%	53,068	365,833	749,814	
6	9/1/2006	757,011	20%	148,514	365,833	1,262,749	539,693
					5.8%		
7	9/1/2007	1,262,749	-23%	(284,951)	372,726	372,726	
8	9/1/2008	605,071	1%	8,833	372,726	750,894	
9	9/1/2009	241,179	12%	27,976	269,155	1,107,153	0

The choice between a series of short-term GRATs and a long-term GRAT is not as clear as the discussion above suggests. It is possible, for example, that an increase in the § 7520 rate between the time the first GRAT was established and the times the subsequent ones are established may outweigh the advantage of separating different years' investment experiences. Additionally, a change in tax law during the time a grantor planned to establish successive short-term GRATs might prevent the creation of some of the planned-for GRATs.

The second advantage the 2-year term has over a longer term is the reduced exposure to the risk that the grantor will die during the term. Some portion of the trust will be included in the gross estate of the grantor if she dies while the GRAT is in effect under § 2033 or 2036 or some combination of the two.[32]

[32] See Appendix A for a discussion of how a grantor's interest in a GRAT is likely to be treated for estate tax purposes if the grantor dies before the annuity term ends.

The grantor of a GRAT does not explicitly retain the right to income. Instead, she retains the right to an annuity which may be more or less than the actual income received by the trust. The IRS treats this type of retained interest as if it were the right to receive the income from a portion of the trust corpus. That portion is required to be included in the gross estate. The included portion is that fraction of the corpus which would be required to be invested at the § 7520 rate in effect on the date of the grantor's death to produce annual income equal to the required annuity payment.[33]

Consider the following example:

> **Example 4**: G transferred $1,000,000 to a GRAT to pay him an annuity of $100,000 per year for the lesser of 10 years or his remaining lifetime. At the end of the trust period, the trust property was to be distributed to G's son S. G died at the beginning of the 6th month during the 9th year when the trust was worth $2,000,000 and the § 7520 rate was 10%. G's estate will be required to include $1,000,000 in his gross estate because $1,000,000 would be required to be invested at 10% to produce income equal to the $100,000 annuity.

If a GRAT is established by joint contributions made by the beneficiary of the annuity interest and by the beneficiary of the remainder, and if each has contributed an amount equal to the actuarial value of her interest in the trust, § 2036 ought not to

$P=\frac{A}{i}$ $P=\frac{A}{i}$

[33] "The portion of the trust's corpus includible in the decedent's gross estate for Federal estate tax purposes is that portion of the trust corpus necessary to yield the decedent's . . . retained annuity . . . as determined in accordance with section 20.2031-7 (or section 20.2031-7A, if applicable)." Treas. Reg. § 20.2036-1(c)(2); Rev. Rul. 82-105, 1982-1 C.B. 133.

The formula for calculating the portion of the principal to be included is as follows:

$$P=\frac{A}{i}$$

In this formula, "A" equals the annuity amount, "i" equals the § 7520 rate, and "P" equals the portion of the trust principal to be included.

$P=\frac{A}{i}$

apply on the death of the annuitant. § 2036 applies only if the decedent has not received adequate and full consideration in money or money's worth for her transfer.

Each time one of a chronological series of short-term GRATs terminates and distributes its excess value to its remainder beneficiaries, the distributed amount is protected from possible inclusion in the grantor's gross estate.

2. Reasons to Choose a Long-Term GRAT

When funding annuity payments is likely to be a problem because of insufficient cash flow from the GRAT assets, a long-term GRAT, calling for either constant or graduated payments, may provide a good solution. If the term is sufficiently long and if the annuity payments are scheduled to increase by 20% each year, the amount of required payments in the initial years will be quite small. The table below shows the percentage annuity payment required to be paid in GRATs that last, 10 years, 15 years, 20 years, and 25 years in order to produce a zero taxable gift using the assumption that the Code § 7520 rate is 2.0%.

Table 4

Years	Annuity %
10	11.13%
15	7.78%
20	6.12%
25	5.12%
30	4.46%

The longer term has an additional advantage in a low interest rate environment of locking in the low interest rate applicable at the beginning of the GRAT.

On the downside, the longer term increases the possibility that the GRAT will fail to produce any transfer tax savings because the death of the grantor or investment losses occur before the end of the term. As discussed below, in some cases this risk can be managed by careful monitoring.

3. <u>Capitalizing on Disparities Between Actual Life Expectancy and Life Expectancy Under IRS Tables</u>

[a] In General

GRAT terms are usually measured by fixed terms of years. If, however, the life expectancy of the grantor or her spouse is less than the life expectancy assumed in the IRS tables, a GRAT measured by the life of the grantor or her spouse may produce significant transfer tax savings.

[b] Revocable Spousal Annuity

Use of a revocable spousal annuity payable for the duration of a spouse's life could achieve significant transfer tax savings if, at the time of the GRAT's creation, the spouse has less than the average life expectancy for a person of his age. The IRS is required to assume that a selected measuring life has an average life expectancy, as determined by tables set forth in the Treasury Regulations, no matter what the individual's actual life expectancy is unless she has an incurable illness or other deteriorating physical condition that gives her a 50% chance of dying within one year.[34]

Suppose, for example, that the grantor's 50-year old spouse has a condition that decreases his life expectancy substantially but which is not expected to cause his death within a year. The donor could create a GRAT the terms of which provide that the spouse is to receive an annuity payable for the remainder of the spouse's life. The value of the revocable interest, which would be treated as an incomplete gift for gift tax purposes, would be calculated as if the spouse were expected to live for another 33 years. This calculation is likely to cause a significantly higher portion of the transfer to be treated as an incomplete gift than the actual value of the spouse's revocable interest in the GRAT. If the donor transferred $1,000,000 to a GRAT to pay a $100,000 annuity

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[34] $P=\frac{A}{i}$ Treas. Reg. §§ 25.7520-1(b)(2) and 25.7520-3(b)(3).

$$P=\frac{A}{i}$$

to her spouse for the rest of the spouse's life in a month in which the IRS 7520 rate is 1.4%, she would be able to reduce the amount of her taxable gift by about $970,000, the actuarial value of a 50 year old's right to receive $100,000 per year for life from a $1,000,000 fund. If the property produces a rate of return of 5% and the spouse dies at the end of two years, property worth about $897,000 can pass to the grantor's children at the price of a gift tax on only $30,000.[35]

[c] <u>Measuring the Term of the GRAT by the Grantor's Life</u>

Similar results can be achieved if the grantor's life expectancy is less than the life expectancy assumed in the IRS's tables unless she has an incurable illness or other deteriorating physical condition that gives her a 50% chance of dying within one year.

Whether a GRAT, the term of which is measured by the grantor's life and the remainder interest in which was transferred by gift, achieves any transfer tax savings depends on the rate of return generated by the GRAT assets prior to the transferor's death. The portion of the GRAT assets that are includable in the gross estate of the grantor is a fraction, the numerator of which is the amount of the annuity and the denominator of which is the § 7520 rate at the time of the grantor's death.

Suppose, a 50-year old grantor created a GRAT that was required to pay her an annuity for life of $70,000. She funded the GRAT with $1,000,000 in a month in which the § 7520 rate was 1.4%. She would be able to reduce the amount of her taxable gift by about $948,390, the actuarial value of a 50 year old's right to receive $70,000 per year for life from a $1,000,000 fund when the § 7520 rate is 1.4%.

Suppose that the GRAT property produces an annual rate of return of 10%, that the grantor lives for 10 years, and that the § 7520 rate is 6% at the time of her

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[35] $P = \frac{A}{i}$ Treas. Reg. § 25.2701-2(a)(6) defines a "qualified interest" as a revocable interest payable to the transferor's spouse so long as the interest meets the requirements of a qualified interest but for the transferor's retained power to revoke the interest.

$$P = \frac{A}{i}$$

death. The trust property will be worth about $1,478,123, only $1,166,667 of which will be included in her gross estate. As a result, property worth $389,268 can pass to the grantor's children at the price of a gift tax on only $51,610.

Transfer tax savings could also be achieved if the grantor created a GRAT in which she retained an annuity for life and simultaneously sold the remainder interest for its full actuarial value. In this case, § 2036's exception for transfers for adequate and full consideration in money or money's worth should protect the GRAT from inclusion in the grantor's gross estate.

Consider the following example:

> **Example 5:** G, who is 50 years old, owns an interest in the family business worth $1,000,000. The business has a good cash flow and she regularly receives annual distributions from the company of $70,000. An existing trust for her children has assets worth $300,000. G agrees with the trustee of the children's trust that she will create a GRAT that gives her the right to receive $70,000 per year for life and will name the trust as the remainder beneficiary in exchange for a payment from the trustee of $51,610, an amount equal to the actuarial value of the remainder if the § 7520 rate is 6%. G's creation of the GRAT should not be a taxable gift, and, when she dies, there should be no inclusion in her gross estate of any portion of the trust property under § 2036. If the children's trust is a grantor trust, G will not recognize gain on the sale of the remainder interest to the trust.

The IRS could argue that the adequacy of the consideration must be measured against the full fair market value of the property on the date of the sale, not the merely the value of the remainder interest. If this is the proper measure, consideration equal to the value of the remainder would be inadequate. The IRS had some early success with this position.[36] More recent cases have supported the position that the consideration need only be equal to the value of the remainder interest.[37]

When the remainder sale technique is used, great care must be taken to determine accurately the value of property transferred to the GRAT. If the consideration received by the grantor for the remainder interest is less than its value, even slightly less, the full value of the GRAT property will be included in the grantor's gross estate under § 2036, reduced under § 2043 only by the amount of the consideration actually paid.

One method of minimizing the risk of understating the purchase price is to use a price adjustment clause that would increase the purchase price by the excess, if any, of the value of the remainder interest, as finally determined for federal gift tax purposes, over the purchase price. The grantor would report the transaction of her gift tax return, filed for the year within which the transaction took place, as a non-gift completed transaction within the meaning of Treas. Reg. § 301.6501(c)-1(f)(4). If the IRS does not audit the gift tax return (or audits but does not contest the value), the value of the transfer should be fixed for estate tax purposes once the time for assessing gift tax on the transfer has expired under § 6501, generally three years after the filing of the gift tax return.[38] If the IRS audits the return and a higher value for the remainder is ultimately established by

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36 $P=\frac{A}{i}$ It was sustained in *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961), *Estate of Gregory v. Commissioner,* 39 T.C. 1012 (1963); *United States v. Past*, 347 F.2d 7 (9th Cir. 1965); and *Gradow v. United States,* 11 Cl .Ct. 808 (1987).

$$P=\frac{A}{i}$$

37 $P=\frac{A}{i}$ *See, e.g., Wheeler v. United States,* 116 F.3d 749 (5th Cir., 1997), *Estate of D'Ambrosio v. United States*, 101 F.3d 309, 312 (3rd Cir. 1996), and *Estate of Magnin v. Commissioner,* 184 F. 3d 1074 (9th Cir. 1999). For a good discussion of these cases, see Jensen*, Estate and Gift Tax Effects of Selling a Remainder: Have D'Ambrosio, Wheeler, and Magnin Changed the Rules*?", 4 Florida Tax Rev. 537 (2000).

$$P=\frac{A}{i}$$

38 $P=\frac{A}{i}$ § 2001(f).

agreement or by a court, the price adjustment clause would require an additional payment by the purchaser of the remainder interest. The additional payment together with the original payment should satisfy the "adequate and full consideration in money or money's worth test" of § 2036(a).[39]

Another, similar method of minimizing the risk of understating the purchase price is to use a defined value clause that limits the portion of the remainder interest transferred to the portion that had a value equal to the amount of the purchase price. For example, if the parties believe the value of the remainder interest is $500,000, the agreement could provide that the purchaser would be designated as the beneficiary of a fraction of the remainder interest, the numerator of which is $500,000 and the denominator of which is the value of the remainder interest as finally determined for gift tax purposes. If it is later determined that the value of the remainder is actually $600,000, the effect of this clause is to limit the portion of the remainder transferred to a 5/6th interest. The value of that interest will be equal to the purchase price paid by the

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$$P=\frac{A}{i}$$

[39] $P=\frac{A}{i}$ The IRS generally takes the position that a price adjustment clause may not protect a transferor from gift tax (see, for example, *Commissioner v. Procter,* 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944); *Ward v. Commissioner*, 87 T.C. 78 (1986); *Harwood v. Commissioner*, 82 T.C. 239 (1984), *aff'd* 786 F.2d 1174 (1986); *Estate of McClendon v. Commissioner,* 66 T.C.M. 946 (1993), *rev'd on other grounds,* 77 F. 3d 477 (5th Cir. 1995); Rev. Rul. 86-41, 1986-1 C.B. 300). But this should not prevent this type of clause from applying for purposes of § 2036(a). The various reasons for rejecting price adjustment clauses for gift tax purposes, (i) the characterization of the clause as creating a condition subsequent to the gift, (ii) the fact that effective price adjustment clauses would discourage gift tax audits, (iii) the possibility that the donees, who would not be parties to the tax litigation, might not make the adjustment payment, and (iv) the fear that giving effect to the provision would obstruct justice because courts would have to pass on a tax issue that became moot simultaneously with the rendering of the decision do not provide a rational for rejecting a price adjustment clause for § 2036(a) purposes. The price adjustment would occur prior to the estate tax issue arising, gift tax audits would not be discouraged and judicial judgments would not become moot because accepting a price adjustment clause for estate tax purposes does not compel accepting it for gift tax purposes, and if the transferee did not honor the price adjustment clause, § 2036(a) would obviously apply. *See also King v. United States,* 545 F. 2d 700 (10th Cir. 1976), which gave effect to a price adjustment clause for gift tax purposes.

$$P=\frac{A}{i}$$

purchaser. As a result, 5/6th of the remainder, the only portion actually transferred, should be protected for § 2036(a).[40]

For the sale of the remainder interest approach to work, the purchaser must have sufficient funds to make the purchase. A gift by the grantor to the purchaser shortly before the transaction is likely to be characterized by the IRS as a gift of the remainder interest to the purchaser for purposes of § 2036.[41] If the prospective purchaser does not have sufficient funds, a married grantor whose spouse has sufficient funds could avoid this issue by selling the remainder interest to her spouse. The spouse could then gift the remainder interest to a trust for the children. § 2036 would not apply to the grantor, because she has received adequate consideration; it would not apply to the spouse because he has not retained an interest in the property.

The joint purchase technique can be used when the grantor is about to purchase a new asset. Each of the grantor and the intended remainder beneficiary would contribute the appropriate portion of the purchase price to the trustees of the GRAT, and the trustee would purchase the asset. The grantor would receive a qualified annuity interest in the asset; the remainder beneficiary would receive the remainder.

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40 $P=\frac{A}{i}$ Definitional clauses of this sort are similar to the formula clauses that are sanctioned in the charitable remainder trust regulations, in the § 2702 regulations, and in the disclaimer regulations. Although the use of definitional clauses has not been specifically approved by the IRS in a case involving a lifetime gift, the IRS has implicitly sanctioned their use in a technical advice memorandum dealing with estate tax issues. TAM 8611004 (Nov. 15, 1985).Similar clauses were approved, for gift tax purposes, by the 3rd Circuit in *McCord v. Commissioner,* 461 F.3d 614 (5th Cir. 2006) by the Tax Court and the 8th Cir. in *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008), *aff'd,* 586 F.3d 1061 (8th Cir. 2009) by the Tax Court and the 9th Circuit in Estate of *Petter v. Commissioner*, TC Memo 2009-280 (2009), *aff'd*, 108 AFTR 2d 2011-5593 (9th Cir. 2011) by the Tax Court in *Hendrix v. Commissioner, TC Memo 2011-133(2011,* and most recently by the Tax Court again in *Wandry v. Commissioner,* T.C. Memo 2012-88. See, generally, McCaffrey, *Formula Valuation – Shield Against Gift Tax Risk or Invitation to Audit?,* 42-11 Univ. Of Miami Center on Est. Planning 1103 (2008), McCaffrey and Kalik, *Using Valuation Clauses to Avoid Gift Taxe*s, 125 Trusts and Estates 47 (Oct. 1986).

$$P=\frac{A}{i}$$

41 $P=\frac{A}{i}$ TAM 9206006 (February 7, 1992).

$$P=\frac{A}{i}$$

The argument for § 2036 inclusion in the case of the joint purchase is more difficult for the IRS to make than in the case of the sale of the remainder interest. This is so because § 2036 requires a transfer of property by the grantor to another person. In a properly structured joint purchase, the grantor is not transferring property to another. She's simply purchasing a life estate (or a lesser term of years) for herself.

If a GRAT is established by joint contributions made by the beneficiary of the annuity interest and by the beneficiary of the remainder, and if each has contributed an amount equal to the actuarial value of her interest in the trust, § 2036 ought not to apply on the death of the annuitant. § 2036 applies only if the decedent has not received adequate and full consideration in money or money's worth for her transfer.

In Private Letter Ruling 9515039,[42] the IRS determined that § 2036 did not apply in the case of such a joint purchase when the obligation to pay the annuity was guaranteed by the holder of the remainder interest who had sufficient assets, independent of her interest in the jointly purchased property, to satisfy the annuity. The IRS cited Rev. Rul. 77-193[43] in support of its conclusion. In that ruling, the IRS had concluded that § 2036 did not apply to a transfer of property in exchange for the personal obligation of a transferee that was not satisfiable solely out of the transferred property and the amount of which was not determined by the size of the income generated by the transferred property. In the absence of such a guarantee, however, the IRS may have characterized the annuity as a retained interest in property transferred by the decedent.

As in the case of the sale of a remainder approach, the purchaser must have sufficient funds to make the purchase. A gift by the grantor to the purchaser shortly

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42 $P=\frac{A}{i}$ PLR 9515039 (January 17, 1995).

$P=\frac{A}{i}$

43 $P=\frac{A}{i}$ Rev. Rul. 77-193, 1977-1 C.B. 273.

$P=\frac{A}{i}$

before the transaction is likely to be characterized by the IRS as a gift of the remainder interest to the purchaser for purposes of § 2036.[44]

C. The Amount of Each Annuity Payment

1. Using a Formula to Define the Annuity Amount

When a GRAT is funded with difficult to value assets, such as, for example, interests in family limited partnerships, the amount of the annuity payment should be defined by formula. The use of a formula to define the amount of the annuity rather than a provision that requires the payment of a specific dollar amount protects the GRAT's grantor from any significant gift tax if the IRS successfully challenges her valuation. The consequence of a successful challenge would be an increase in the amount of her annuity.

Consider the following example.

> **Example 6:** G creates a 10-year GRAT and transfers what she believes to be $1 million worth of stock in the X corporation to the GRAT in a month in which the § 7520 rate is 4%. G retains the right to receive an annuity equal to $123,100 per year for 10 years. This annuity will protect $1 million worth of transferred property from the gift tax because the right to receive $123,100 per year for 10 years has an actuarial value of $1,000,000. If the IRS successfully argues that the shares of X Corp. transferred to the GRAT were worth $2,000,000, double her estimate, the amount of G's taxable gift will be $1 million. If, instead, the terms of G's GRAT had defined her annuity amount as the minimum amount necessary cause her annuity payments to have a value equal to 99% of the fair market value of the transferred X stock as finally determined for federal gift tax purposes. G's taxable

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44 $P = \frac{A}{i}$ See, for examples, *Davies v. Commissioner,* 40 T.C. 525 (1963), in which the Tax Court seemed to characterize a cash gift made by a nondomiciliary alien to his son as a gift of United States real estate when the purpose of the cash gift was to enable the son to purchase a parcel of United States real estate from him.

$$P = \frac{A}{i}$$

> gift would be 1% of the value put on the X stock by the IRS. Any increase in value would cause the trust to be required to increase her annuity payment from the amount she had thought it would be to the amount necessary to cause her taxable gift to be 1% or, in this case, $20,000.[45]

For some individuals, the ability to define a difficult-to-value gift by means of a formula will be the most important advantage of establishing a GRAT. As discussed above, other taxpayer approaches toward minimizing valuation risks by means of various types of adjustment clauses have generally been rejected by the IRS. Clauses that require post-transfer adjustments in the price of a purchased asset or in the quantity of property transferred, if the value of the transferred property is later determined to be greater than the original estimate, with few exceptions, have been rejected by the courts and by the IRS.[46]

A formula clause that works simultaneously with (rather than after) the gift and works to define the amount of the gift should not be disregarded by the IRS

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[45] $P=\frac{A}{i}$ It is possible to provide a formula that produces an annuity with a value exactly equal to the value of the transferred property. If there is a possible valuation problem, however, the IRS might attempt to apply the so-called *Procter* doctrine. In *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), the Fourth Circuit invalidated, for gift tax purposes, an agreement that required a transferee to return property to a transferor if the transfer was held to be subject to the gift tax. The Fourth Circuit said that the agreement was void as against public policy since "it has a tendency to discourage the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift." A formula that produces a small taxable gift should avoid this risk.

$$P=\frac{A}{i}$$

[46] $P=\frac{A}{i}$ *E.g., Ward v. Commissioner*, 87 T.C. 78 (1986); *Harwood v. Commissioner*, 82 T.C. 239 (1984); Rev. Rul. 86-41, 1986-1 C.B. 300; TAM 9309001 (Sept. 30, 1992). *But see King v. United States*, 545 F.2d 700 (10th Cir. 1976). For discussions of this issue *see* McCaffrey, *Tax Tuning the Estate Plan by Formula*, 33-4 Univ. of Miami Law Center on Estate Planning § 4 (2000); Peterson, *Savings Clauses in Wills and Trusts*, 13 Tax Mgmt. Est., Gifts & Trusts Journal 83 (1988) and McCaffrey & Kalik, *Using Valuation Clauses to Avoid Gift Taxes*, 125 Tr. & Est. 47 (Oct. 1986).

$$P=\frac{A}{i}$$

because, without the clause, there would be no way to determine the amount of the gift. The following is an example of a definitional formula clause:

> "I hereby transfer to the trustees of the T Trust a fractional share of the property described on Schedule A. The numerator of the fraction is $100,000 and the denominator is the value of such property as finally determined for federal gift tax purposes."

The IRS objects to this kind of clause as well as the adjustment clauses discussed above because it forces the IRS to use its limited resources to challenge taxpayer valuations even though a successful challenge would not produce any immediate additional tax revenue.[47]

The validity of a definitional formula clause with the appropriate tie-in to final gift tax values may eventually be conceded by IRS.[48] But until it has been, the GRAT provides the only sure way to protect against the gift tax risk of valuation challenges.

For individuals who want to make gifts of difficult to value property, combining a gift with a GRAT may permit the GRAT's valuation formula to protect the gift from unanticipated gift tax. For example, suppose G wants to transfer $1 million worth of the shares of X Corp. to a trust for the benefit of C, her child. She believes that 100 shares have a value of $1 million but is unwilling to pay a gift tax on any value of

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[47] $P=\frac{A}{i}$ A 2001 Non-Docketed Service Advice Review opinion as to whether a savings clause which gifted limited partnership interests to be valued at certain dollar amounts should be recognized for tax purposes warned against recognizing formula clauses. "To give substance to this clause effectively nullifies our regulations, defeats the gift tax, obstructs justice and hampers the administration of the tax laws. . . . Fair administration of the gift tax will become even more difficult if formula clauses are given effect, for scarce resources cannot reasonably be expended examining returns if the examination will have no tax effect. 2001 IRS NSAR 0417, 2001 WL 34056189 (IRS NSAR)(2/27/01).

$$P=\frac{A}{i}$$

[48] $P=\frac{A}{i}$ See cases cited in Footnote 40.

$$P=\frac{A}{i}$$

these shares in excess of $1 million. She could transfer 101 shares of X Corp. to the trustee of a GRAT, the terms of which require the trustee to pay her an annuity equal to such percentage of the finally determined gift tax value of the property as is required to produce an annuity equal to the value of the transferred property as finally determined for gift tax purposes in excess of $1 million.

2. <u>Using a Pattern of Increasing Annuity Amounts</u>

As discussed above, the regulations permit annuity payments each year of unequal amounts to be treated as qualified annuity payments so long as the amount to be paid in any year is determinable from inception except to the extent that the payment in any one year exceeds the payment in the preceding year by more than 20%. In general, a pattern of increasing annuity payments will produce more value for the beneficiaries at the end of the term than would a pattern of constant annuity payments if the property grows in value at a relatively constant rate throughout the term of the GRAT. The table below shows the annuity percentages required to zero out a GRAT assuming a 4.2% § 7520 rate, a pattern of annuity payments that increases the annuity payment each year by 20% and terms of 20 years, 15 years, 10 years and 5 years.

Table 5

Years	20 Years	15 Years	10 Years	5 Years
1	0.998%	2.161%	5.091%	15.405%
2	1.197%	2.593%	6.110%	18.486%
3	1.437%	3.112%	7.332%	22.183%
4	1.724%	3.734%	8.798%	26.619%
5	2.069%	4.481%	10.557%	31.943%
6	2.482%	5.377%	12.669%	
7	2.979%	6.452%	15.203%	
8	3.575%	7.743%	18.243%	
9	4.290%	9.291%	21.892%	
10	5.148%	11.149%	26.270%	
11	6.177%	13.379%		
12	7.413%	16.055%		
13	8.895%	19.266%		
14	10.674%	23.120%		
15	12.809%	27.744%		
16	15.371%			
17	18.445%			

Years	20 Years	15 Years	10 Years	5 Years
18	22.134%			
19	26.561%			
20	31.873%			
NPV	100.000%	100.000%	100.000%	100.000%

Table 6 shows the extra value passing to the remainder beneficiaries of a 20 year and of a 15 year GRAT, assuming increasing GRAT payments rather than constant payments. In each case, a 4.2% § 7520 rate an annuity pattern sufficient to zero out the taxable gift, and an annual investment return of 10% are assumed.

Table 6

		20 Years					15 Years		
Year #		Increasing Payments $1,000,000		Constant Payments $ 1,000,000			Increasing Payments $1,000,000		Constant Payments $ 1,000,000
1	1.00%	$1,090,023.51	7.49%	$1,025,109.25		2.16%	$1,078,391.54	9.12%	$1,008,796.57
2	1.20%	$1,187,054.06	7.49%	$1,052,729.42		2.59%	$1,160,300.53	9.12%	$1,018,472.79
3	1.44%	$1,291,393.32	7.49%	$1,083,111.61		3.11%	$1,245,214.40	9.12%	$1,029,116.64
4	1.72%	$1,403,293.27	7.49%	$1,116,532.01		3.73%	$1,332,396.41	9.12%	$1,040,824.87
5	2.07%	$1,522,935.33	7.49%	$1,153,294.46		4.48%	$1,420,828.74	9.12%	$1,053,703.93
6	2.48%	$1,650,404.15	7.49%	$1,193,733.16		5.38%	$1,509,142.85	9.12%	$1,067,870.89
7	2.98%	$1,785,654.92	7.49%	$1,238,215.72		6.45%	$1,595,534.60	9.12%	$1,083,454.54
8	3.57%	$1,928,472.82	7.49%	$1,287,146.54		7.74%	$1,677,661.03	9.12%	$1,100,596.57
9	4.29%	$2,078,423.01	7.49%	$1,340,970.44		9.29%	$1,752,514.70	9.12%	$1,119,452.79
10	5.15%	$2,234,788.79	7.49%	$1,400,176.73		11.15%	$1,816,271.24	9.12%	$1,140,194.64
11	6.18%	$2,396,495.84	7.49%	$1,465,303.65		13.38%	$1,864,104.45	9.12%	$1,163,010.67
12	7.41%	$2,562,019.23	7.49%	$1,536,943.26		16.06%	$1,889,962.20	9.12%	$1,188,108.30
13	8.90%	$2,729,269.73	7.49%	$1,615,746.83		19.27%	$1,886,295.19	9.12%	$1,215,715.70
14	10.67%	$2,895,454.99	7.49%	$1,702,430.76		23.12%	$1,843,728.83	9.12%	$1,246,083.84
15	12.81%	$3,056,910.43	7.49%	$1,797,783.08		27.74%	$1,750,666.65	9.12%	$1,279,488.79
16	15.37%	$3,208,893.41	7.49%	$1,902,670.64					
17	18.44%	$3,345,333.07	7.49%	$2,018,046.95					
18	22.13%	$3,458,526.75	7.49%	$2,144,960.89					
19	26.56%	$3,538,771.89	7.49%	$2,284,566.23					
20	31.87%	$3,573,920.03	7.49%	$2,438,132.10					

The other obvious advantage of the increasing payment GRAT is the relatively small annuity payments in earlier years. This feature makes the increasing payment GRAT particularly attractive for a difficult to value property that is not expected to produce significant cash flow for some period of time. GRATs annuity payments must be timely made. This is difficult to do if cash flow is low and the use of distributions in kind requires annual valuations of the GRAT property. An increasing payment GRAT can be funded with sufficient cash to provide for annuity payments over the initial years of the GRAT until the year when a liquidity event is anticipated for the GRAT property.

For example, consider a 20-year increasing payment GRAT funded with non-income producing property worth $1,000,000 and cash of $55,000 in a month in which the § 7520 rate is 1.4%. The initial annuity amount is .66% of $1,085,000, that amount, which when increased by 1.2% per year will produce an annuity stream with a net present value of $1,055,000. So long as the cash is invested to produce a positive return, no matter how small, the GRAT will have sufficient cash to pay the annuity amounts during its first five years.

D. <u>Using Single Asset GRATs</u>

A grantor who has more than one asset the future return on which she would like to protect from transfer taxes by using the GRAT technique should consider transferring each asset to a separate GRAT. Multiple GRATs for separate assets prevent underperforming assets from diluting the effectiveness of the good performers. The principle is the same as the one that recommends use of a chronological series of short-term GRATs rather than a single long-term GRAT to maximize the advantage to the remainder beneficiaries of the years of good investment return.

This approach obviously adds complexity but can substantially enhance the ability of the GRAT technique to shift value to the next generation. Suppose, for example, that G, had two assets she wished to transfer to a 2-year GRAT - $500,000 worth of shares of the X Corp. and $500,000 worth of shares of the Y Corp. in a month in which the § 7520 rate was 4.2%. Suppose during the 2-year term of the GRAT that the shares of X increased by 10% per year and that the shares of Y decreased by 10% per year. If she had established a single GRAT and had funded it with the shares of X and Y, at the end of the 2-year term, there would be nothing in the trust to pass to her remainder beneficiaries. The excess return on the X stock would be needed to compensate for the poor performance of the Y stock. On the other hand, if she had established two GRATs and had funded one with the shares of X and the other with the shares of Y, the remainder beneficiary would have received property worth $46,698 at the end of the 2-year term.

E. Using Clauses That Reimburse the Grantor for Income Taxes

Many grantors would like their trustees to have the power to reimburse them for their income tax liability attributable to trust income, in order to provide them with relief from the tax burden if, in the future, they believe they can no longer afford to sustain it. Rev. Rul. 2004-64, discussed above, concludes that the mere existence of that discretion, by itself (whether or not exercised) will not cause the value of the trust's assets to be includible in the grantor's gross estate but that this discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between the grantor and the trustee regarding the trustee's exercise of this discretion; a power retained by the grantor to remove the trustee and name herself as successor trustee; or applicable local law subjecting the trust assets to the claims of the grantor's creditors) may cause inclusion of Trust's assets in the grantor's gross estate for federal estate tax purposes.

If it is unclear whether local law would subject trust property to the claims of its grantor's creditors because of a trustee's power to reimburse her for her income taxes attributable to trust income, inclusion of a reimbursement provision would be risky. In this case, the reimbursement provision should, by its terms, be operative only if, as a matter of law in the applicable state, the reimbursement provision would not cause the trust assets to be subject to the claims of the grantor's creditors.[49]

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[49] $P=\frac{A}{i}$ Since of May 31, 2005, but effective as to all trusts, regardless of when created, New York law has provided, "[A] disposition in trust shall not be considered to be for the use of the creator under paragraph (a) of this section by reason of the trustee's authority to pay trust principal to the creator pursuant to section 7-1.11 of this article. Nor shall a disposition in trust be considered to be for the use of the creator under paragraph (a) of this section where the trustee is authorized under the trust instrument or any other provision of law to pay or reimburse the creator for any tax on trust income or trust principal that is payable by the creator under the law imposing such tax or to pay any such tax directly to the taxing authorities. No creditor of a trust creator shall be entitled to reach any trust property based on the discretionary powers described in this paragraph." New York Estates, Powers and Trusts Law § 7-3.1(d).

$$P=\frac{A}{i}$$

F. Planning for the Marital Deduction

The possible application of the marital deduction should be considered in connection with the creation of a GRAT by a married grantor. If a portion of a GRAT is included in the grantor's gross estate, and if she is survived by her spouse, the marital deduction could be disallowed for any portion of the included interest even if the transferor bequeaths her entire estate to her surviving spouse.

Suppose, for example, that the terms of the GRAT require any annuity amounts payable after the death of the grantor to be paid to the grantor's estate and that the remainder is to be paid to her children. Suppose also that, under the grantor's will, annuity payments received by the estate are to be paid to the surviving spouse. Because the trust will end in favor of the remainder beneficiaries, the annuity payable to the surviving spouse will be a nondeductible terminable interest.[50] To avoid this result, while maintaining flexibility, the terms of the GRAT instrument might give the grantor a power of appointment exercisable over such portion of the remainder interest in the trust as is includible in her gross estate. She could then exercise this power in favor of her husband. If the grantor's husband is to receive both the remaining annuity payments and the property held in the GRAT at the end of its term, the nondeductible terminable interest rule should not apply.

Alternatively, the power of appointment could be exercised in favor of a marital deduction trust to which the grantor specifically bequeaths her remaining annuity payments. If this approach is used, the trust instrument of the GRAT should require that if the annuity payments are to be made to a trust for the grantor's surviving spouse that is intended to qualify for the marital deduction under § 2056(b)(5) or (b)(7), (1) (a "marital trust") in any year in which the income earned by the GRAT is more than the annuity amount, the GRAT trustees will pay the excess amount to the trustees of the marital trust,

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50 $P=\frac{A}{i}$ §2056(b)(1).

$$P=\frac{A}{i}$$

and that the surviving spouse will have the power to direct that the trust property be invested to produce a reasonable rate of income.

G. Avoiding Spendthrift Clauses

Drafters often include a provision in trust agreements (commonly referred to as “spendthrift clauses”) that prohibit trust beneficiaries from transferring their interests in trusts to others. These clauses should not be used to prevent GRAT beneficiaries from transferring their interests. As discussed in further detail below, there may be good transfer tax reasons for arranging for the grantor or remainder beneficiaries to sell or otherwise dispose of their interest in a GRAT.

H. Identifying the Remainder Beneficiaries

1. In General

In order to maintain flexibility for dealing with future circumstances, the grantor of a GRAT should consider designating a separate grantor trust as the remainder beneficiary of her GRAT. The beneficiaries of the separate grantor trust should include beneficiaries who are assigned to the grantor’s children’s (or higher) generation in order to prevent the termination of the annuity period from being treated as a taxable termination for generation-skipping transfer tax purposes.[51] Inclusion of the grantor’s spouse as a beneficiary will ensure that GRAT profits are available for his support if the other assets of the grantor and her spouse become insufficient. Use of a grantor trust will enable the grantor to continue to pay the income taxes on the investment earnings of the GRAT profits. It will also prevent the imposition of income tax on the grantor if, at the time of the GRAT’s termination, the GRAT holds property subject to a debt in excess of its basis and will enable the grantor to purchase appreciated property from the remainder beneficiary trust for cash or other property with a basis equal to fair market value in order

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[51] $P=\frac{A}{i}$ §2612(a)(1).

$P=\frac{A}{i}$

to eliminate the tax disadvantage to the remainder beneficiary trust, after the grantor's death, of holding low basis property.

2. Mortality Issues

Use of a separate trust that is treated as wholly owned by the grantor under the grantor trust rules will facilitate future transfers of the remainder interests, as discussed in Part VI. D., to minimize estate tax exposure.

3. Generation-Skipping Transfer Tax Issues

[a] In General

Use of a separate grantor trust as the remainder beneficiary of a GRAT may also facilitate generation-skipping transfer tax planning. The zero valuation rule of § 2702 does not apply for generation-skipping transfer tax purposes.[52] The non-applicability is not helpful from a planning point of view because, in most cases, the generation-skipping transfer tax does not apply to a transfer to a trust in which the grantor has retained an interest or, if it applies at all, applies to all trust property, no matter how fragmented its interests are. Consider the following example:

> **Example 7**: G transferred $1,000,000 to a trust to pay income to herself for 10 years, remainder to her granddaughter. The amount of G's gift to her granddaughter will be $1,000,000 under § 2702. For generation-skipping transfer tax purposes, however, the gift will be treated as a gift to a trust rather than to her granddaughter.[53] As a result, no generation-skipping

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52 $P=\frac{A}{i}$ The explanation that accompanied the regulations when proposed clearly so states: "Although [sections 2701 and 2702] apply to determine the amount of the gift, they do not change the value of the property for other tax purposes. Thus, in general, sections 2701 and 2702 do not apply for purposes of the generation-skipping transfer tax." 56 Fed. Reg. 14321, 14322 (April 9, 1991). Neither the final regulations nor the explanation accompanying them take a contrary position. *See* Explanation preceding final regulations, 57 Fed. Reg. 4250, 4251 (Feb. 4, 1992).

$P=\frac{A}{i}$

53 $P=\frac{A}{i}$ *See* § 2613(a)(2).

> transfer tax will be imposed until the termination of G’s interest in the trust. On the termination of the trust, however, the full value of the trust will be subject to generation-skipping transfer tax.

The result described in Example 7 applies to GRATs as well as to retained income interests. As a result, on the termination of an annuitant’s interest in a GRAT, if the trust property is paid to or held for a skip person, such as the grantor’s grandchild, the property will be subject to the generation-skipping transfer tax.

To avoid this result, it may be advisable to provide that the remainder interest in a GRAT be divided among the grantor’s living children. If the grantor wants a deceased child’s children to receive the portion of the GRAT that the child would have received if the child had survived, it is preferable to provide for such grandchildren by direct compensating gifts or by compensating bequests in the grantor’s will.

Gifts and bequests to grandchildren who are children of a deceased child are preferable since they will be protected from the generation-skipping transfer tax by the so-called “predeceased parent exception.”[54] This exception may apply to transfers from a GRAT to a grandchild but only if that grandchild’s parent is dead at the time of the initial transfer to the GRAT.

If the predeceased parent exception is not available, outright gifts to grandchildren or gifts to trusts for their benefit are generally more tax efficient than transfers to grandchildren of remainder interests in trust. This is so because an outright gift is treated as a direct skip rather than a taxable termination or taxable distribution. The generation-skipping transfer tax imposed on direct skips will usually be lower than the generation-skipping transfer tax imposed on taxable distributions or taxable terminations.

$P=\frac{A}{i}$

[54] $P=\frac{A}{i}$ § 651(e).

$P=\frac{A}{i}$

If the grantor wants to designate a grandchild as the remainder beneficiary of a GRAT, the only way to protect the ultimate distribution to the grandchild from the generation-skipping transfer tax is to allocate sufficient GST exemption to the trust to result in an inclusion ratio of zero. The so called "ETIP" rule of § 2642(f), however, prevents allocation of GST exemption to a GRAT until the termination of the grantor's retained interest. This provision prohibits the allocation of GST exemption to an inter vivos transfer if the transferred property would be included in the gross estate of the grantor (under any provision of the estate tax law other than § 2035) if she died immediately after the transfer. The period of time during which the GST exemption allocation may not be made is referred to in the Code as the "estate tax inclusion period." The ETIP rule is likely to apply to the GRAT because if the grantor died immediately after establishing a GRAT, at least some portion of the trust property would be included in her gross estate.

Because the grantor cannot make any allocation of her GST exemption against the value of the GRAT assets passing to her grandchild until after the term of her retained interest has expired, the exemption is allocated against the value of the assets passing to her grandchild at that time, rather than at the time the GRAT was created. Accordingly, the GRAT does not create leverage that works to reduce the amount of assets otherwise subject to the GST.

[b] <u>Techniques to Reduce the Generation-Skipping Transfer Tax</u>

- **<u>Changing the Transferor</u>**

It may be possible to protect a transfer to grandchildren at the end of a GRAT from the generation-skipping transfer tax by shifting the identity of the transferor with respect to the remainder interest. Suppose, for example, that the terms of a GRAT provided that the GRAT remainder would pass to a trust for the grantor's daughter and the daughter's children at the end of its term but that the daughter also had a testamentary general power of appointment over the remainder exercisable in the event the daughter died before the end of the GRAT term. If the daughter dies before the end of the GRAT term, the actuarial value of the GRAT remainder as of the date of her death will be included in her gross estate. Section 2652(a)(1)(A) provides that the transferor for generation-skipping transfer tax purposes in the case of property subject to the estate tax is the decedent in whose estate the property is subject to tax. The daughter's death before the end of the GRAT term will, therefore, change the identity of the transferor from the original grantor to her daughter. When the GRAT property passes to the trust for the grantor's grandchildren, there will be no generation-skipping transfer tax because the grantor's grandchildren are not skip persons as to the grantor's child. The IRS reached this conclusion in Private Letter Ruling 200227022.[55]

In most cases, the use of a testamentary general power of appointment will not be an acceptable approach because it could expose the daughter's estate to an unacceptably high estate tax. Suppose, for example, a 2-year GRAT was originally funded with $1 million. Suppose the grantor's daughter died toward the end of the second year when the GRAT property was worth $2 million and the actuarial value of the remainder interest was $1.5 million. The daughter's estate would be subject to estate tax on the full $1.5 million.

If a child of the grantor, rather than a trust for her benefit, is the outright beneficiary of the GRAT, the same result should be achieved if she makes a gift of her remainder interest. Section 2652(a)(1)(B) provides that the transferor for generation-skipping transfer tax purposes in the case of property subject to the gift tax is the donor. The child's gift of the remainder interest before the end of the GRAT term should, therefore, change the identity of the transferor from the original grantor to her child.[56] In Private Letter Ruling 200107015, the Service, in a situation involving a charitable lead

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55 $P=\frac{A}{i}$ PLR 200227022 (April 2, 2002).

$P=\frac{A}{i}$

56 $P=\frac{A}{i}$ PLR 200107015 (November 14, 2000).

$P=\frac{A}{i}$

annuity trust rather than a GRAT, concluded that the transfer of a remainder interest by a child of the grantor shifted the identity of the transferor only to the extent of the portion of the trust assets equal to the present value of the remainder interest. For example, if the child gifted her remainder interest in a $1 million GRAT at a time when the remainder interest was worth only $100,000, she would become the transferor with respect to a one-tenth interest in the GRAT. This conclusion is inconsistent with the Service's conclusion in Private Letter Ruling 200227022 discussed above.[57]

In order to protect against an immediate generation-skipping transfer tax on the termination of the GRAT if the Service successfully argues that the child does not become the transferor or that she becomes the transferor as to only a portion of the GRAT, the donee of the child's gift of her remainder interest should be a trust for the benefit of the child's children, and the trust should be structured so that it is a non-skip person as to the original transferor. Non-skip person status could be accomplished, for example, by including the child's spouse or her siblings as additional trust beneficiaries. If the donee is a non-skip person as to the original transferor, no generation-skipping transfer tax will be imposed when the GRAT remainder is paid to that donee.

- **<u>Sale of the Remainder Interest to a Trust That Is Exempt From the Generation-Skipping Transfer Tax.</u>**

If at the time of the creation of a GRAT, there is already in existence a trust for the grantor's grandchildren that has been protected from the generation-skipping transfer tax by the allocation of her GST exemption, and if the GRAT remainder beneficiary is a separate trust, the GRAT remainder beneficiary could sell its remainder interest to the protected trust. The sale, so long as the price paid is equal to the then value of the GRAT remainder interest should not be treated as an addition from the unprotected

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[57] $P=\frac{A}{i}$ The inconsistency may be explained by the IRS's reliance in Private Letter Ruling 200107015 on §2642(e), a section that applies only to charitable lead annuity trusts. This subsection, in the view of IRS, was enacted to ensure that generation-skipping transfer tax would be imposed on transfers from a charitable lead trust to its creator's grandchildren unless GST exemption were allocated to the trust.

$$P=\frac{A}{i}$$

trust to the protected trust. As a result, when the GRAT remainder is paid to the protected trust, the transfer should not be subject to generation-skipping transfer tax.

Assume, for example, that a grantor created a grantor trust a number of years ago and allocated her GST exemption to it ("Trust #1"). Its assets are now worth $1 million. The beneficiaries of Trust #1 include her children, grandchildren and more remote descendants. All future distributions from Trust#1 to the grantor's grandchildren or more remote descendants will be free of generation-skipping transfer taxes because of the GST exemption allocation. The grantor creates a 5-year GRAT in a month in which the § 7520 rate is 4.2%. She transfers property worth $1 million to it. She is entitled to receive an annuity of $220,000 at the end of each of the next 5 years. The actuarial value of the right to receive these annuity payments is $974,000. As a result, she has made a taxable gift of $24,000. The remainder beneficiary of the GRAT is a separate grantor trust for the primary benefit of her children ("Trust #2"). The grantor does not allocate any GST exemption to this new trust because § 2642(f) (the so-called "ETIP" rule) would prevent the allocation from being effective until the end of the 5-year term of the GRAT. Six months later, when the actuarial value of the remainder beneficiary's remainder interest in the GRAT is worth $100,000, Trust #2 sells its remainder interest to Trust # 1 for a price equal to its value of $100,000. The sale, so long as the price paid is equal to the then value of the GRAT remainder interest should not be treated as an addition from the unprotected trust to the protected trust. As a result, when the GRAT remainder is paid to the protected trust, the transfer should not be subject to generation-skipping transfer tax. And when distributions are made from Trust #1 to the grantor's grandchildren, the distributions should not be treated as taxable distributions.

Alternatively, the GRAT remainder beneficiary could enter into a contract with the protected trust to pay to the protected trust an amount equal to the value of the remainder interest at the end of the GRAT. The protected trust would pay the GRAT remainder beneficiary, at the time the contract is entered into, an amount equal to the then value of the remainder interest.[58]

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[58] $P=\frac{A}{i}$ This idea is discussed in Handler and Oshins, *The GRAT Remainder Sale*, 142 Tr. & Est. 33 (Dec. 2002).

I. Targeting the Profit Level

Most GRATs are structured to deliver all of the increase in value of the GRAT's assets over the § 7520 rate to the remainder beneficiaries, no matter how great that increase may be. In some cases a grantor is willing to create a GRAT for the benefit of her children but wants to insure that she will receive property with a certain specified value back from the GRAT and/or that her children's trust will receive property worth no more than a certain maximum value. It is possible to structure a GRAT's provisions to deliver to the remainder beneficiary precisely the amount that the grantor wants it to have so long as the GRAT's property appreciates sufficiently.

For example, suppose G owns $10 million worth of stock in a closely held business that she expects will be sold over the next several years for a price of more than $20 million. She would like her children's trust to receive $5 million of this increase and would like to use the GRAT technique to accomplish this result. But she wants to make sure that she receives back property from the GRAT worth at least $15 million. Her GRAT would provide first that she is to receive an annuity in an amount sufficient to almost zero-out her taxable gift, say 22.59% of the initial value each year if the GRAT is a 5-year GRAT created in a month in which the § 7520 rate is 4.2%. It would then provide that the grantor is to receive, at the end of the GRAT term, property with a value equal to $15 million reduced by the aggregate amount of the five annuity payments, that the children's trust is to receive the balance of the property remaining in the GRAT up to an aggregate amount of $5 million and that the grantor is to receive the balance of the property.

V. SELECTING INVESTMENTS TO ENHANCE THE PROBABILITY OF SUCCESS

A. In General

A successful GRAT is one that produces a remainder interest with a positive value at the end of the annuity term. In order to produce a positive value, the

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$$P=\frac{A}{i}$$

GRAT's internal rate of return, taking into account the timing of its investment gains and losses and the timing of its annuity payments must exceed the § 7520 rate in effect at the time of the GRAT's creation.

Normally, it is impossible to predict accurately the rate of return for any particular investment. Nevertheless, there are certain assets and investment approaches that can enhance the probability of success. These assets and approaches are discussed in this portion of the outline.

B. <u>Using Assets Subject to Restrictions</u>

Some assets are subject to transferability restrictions that are expected to lapse at some future time. Examples include restricted securities that cannot be sold for some period of time because of SEC rules, because of lock up agreements entered into in connection with initial public offerings, or because of employer conditions imposed in connection with the issuance of stock to employees. In most cases, the owner of these shares expects these restrictions to disappear over a period of time. In many cases, the restrictions on transfer will not prevent intra-family transfers, including transfers to GRATs for the benefit of family members.

The existence of these restrictions will provide a basis for discounting the value of the property if it is transferred to a GRAT. If the term of the GRAT extends beyond the term of the restrictions and if a source of funding can be found to satisfy annuity payments that are required before the restrictions are lifted, this kind of property is a likely candidate for transfer to a GRAT.

Suppose, for example, that G owns 100,000 shares of the X corporation the shares of which are traded on the New York Stock Exchange at $10 per share. G's shares, however, cannot be sold by her or her transferees for a period of two years. Assume that this restriction on transferability would result in a valuation discount of 25%.[59] Assume that G transfers her shares to a 2-year GRAT at a time when the § 7520

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[59] $P=\frac{A}{i}$ This discount is assumed for illustrative purposes. The discount allowed for any particular security must be established by a qualified appraiser who will take into account many factors specific to the corporation and the trading pattern of its shares.

rate is 4.2%. She retains the right to a payment equal to 53.17% of the value of the shares ($398,787) at the end of each of the two years. The actuarial value of the right to these two payments is equal to $750,000, the discounted value of her shares. At the end of the first year, her trustees borrow $398,787 from a financial institution to make the required payment to her. At the end of the second year, the trustees sell the stock for $1 million, pay the financial institution $415,000 (including interest), and pay G the second annuity payment. Because the GRAT is a grantor trust for income tax purposes, all of the tax on the gain is paid by G, not by the GRAT. After the required payments are made, there is $186,000 left for the remainder beneficiaries of the GRAT.

This GRAT succeeded despite the fact that the market value of the stock transferred to it did not appreciate in value. The success was entirely attributable to the existence of restrictions at the beginning of the GRAT period that the GRAT creator knew would be lifted before the end of her GRAT.

C. <u>Using Assets With Limited Marketability</u>

The value of some assets, such as non-controlling interests in family controlled entities and fractional interests in tangible property, is determined for gift tax purposes using discounts from the value of their proportional interest in their underlying assets to reflect lack of marketability. For example, the value of each of 25% of the stock in a family business that could be sold for $10 million, a 25% limited partnership interest in a partnership that owns $10 million worth of marketable securities and a 25% interest in a $10 million home is not $2.5 million. Valuation discounts of varying proportions would be used to determine their value for gift tax purposes. If the term of the GRAT extends beyond the period of time that the assets are expected to have limited marketability and if a source of funds can be found to satisfy annuity payments that are required before a market for the property is created, this kind of property is a likely candidate for transfer to a GRAT.

Suppose, for example, that G owns all of the stock of a corporation engaged in the manufacturing business. The corporation could be sold for $10 million.

$$P=\frac{A}{i}$$

G has no present intention of selling the corporation but believes that it is likely to be sold at some time during the next 5 years. She transfers a 25% interest in the corporation to a 5-year GRAT at a time when the § 7520 rate is 4.2%. She retains the right to a payment equal to 22.59% of the value of the shares as finally determined for gift tax purposes at the end of each of the five years. Assume that the value of the shares is $1.375 million after taking a valuation discount of 45%. G would have the right to receive $310,599 at the end of each of the five years. The actuarial value of the right to these five payments is equal to $1,375 million, the discounted value of her shares. At the end of each of the first 4 years, the trustee borrows the funds necessary to make the annuity payments to G. During the fifth year, the corporation is sold to a third party for $10 million. The GRAT's share of the proceeds is $2.5 million. Because the GRAT is a grantor trust for income tax purposes, all of the tax on the gain is paid by G, not by the GRAT. The trustees use the cash to repay the financial institution $1.372 million (including interest), and pay G the final annuity payment of $310,599. After the required payments are made, there is $818,000 left for the remainder beneficiaries of the GRAT.

This GRAT succeeded despite the fact that the market value of the corporation did not appreciate in value. The success was entirely attributable to the elimination of the marketability discount by reason of the liquidity event that occurred during the term of the GRAT.

D. <u>Using Compensatory Stock Options</u>

Compensatory stock options give an employee the right to purchase shares of stock at a price generally equal to the market price of the stock at the time the option is granted. The IRS has ruled that the gift of this kind of option is a completed gift when the employee's right to exercise it is no longer conditioned on her performance of services.[60] The fair market value of these options for gift tax purposes is not limited to their intrinsic value, *i.e.*, an amount equal to the excess of the stock's market value over

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60 $P=\frac{A}{i}$ Rev. Rul. 98-21, 1998-1 C.B. 975.

$P=\frac{A}{i}$

the exercise price. It is generally determined using one of the standard option valuation methods such as the Black-Scholes model. These methods take into account factors such as the exercise price, the current value of the optioned stock, the stock's volatility, expected dividends, the risk-free rate of return over the option's life and the option's remaining life. The IRS has stated that it will accept, for gift and estate tax purposes, a value for non-publicly traded compensatory options derived using the Black-Scholes model or a similar binominal valuation model.[61] As a condition for relying on this safe harbor, the transferor is not permitted to use any marketability discounts generally used in valuing options.

Despite the fact that the use of a Black-Scholes derived value for an option will produce a value in excess of the option's extrinsic value, the transfer of compensatory options can produce excellent results when compared with the transfer of shares of the underlying stock. This is so because of the leverage inherent in the option. If, for example, a share of X stock with a value of $100 is transferred to a GRAT, a 100% increase in the value of the X stock, will produce an increase in value for the GRAT of $100. If an option to purchase that share of stock for 10 years at a price of $100 is transferred to the GRAT, that same 100% increase will translate into a greater percentage increase in value for the GRAT so long as the initial option value is less than the value of the share of stock. Suppose, for example, that the option value determined using the Black-Scholes model is $30. By transferring an asset worth $30, the grantor transfers the right to receive the return on an asset worth $100. As a result, a 100% increase in the value of the stock will result in a value for the option of at least $100, more than a 200% increase in value for the GRAT.

Options valued using the Black-Scholes model are not particularly attractive candidates for outright gifts because the option leverage would work against the donor if the stock failed to appreciate sufficiently in value. As a practical matter, the option itself will not be sold in a market transaction. As a result, the donee will never be

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61 $P=\frac{A}{i}$ Rev. Proc. 98-34, 1998-1 C.B. 983.

$$P=\frac{A}{i}$$

able to capitalize on the value of the option itself but will realize a return only if she is able to exercise the option and sell the underlying stock. Unless the value of the stock increases sufficiently to offset the initial value of the option, the gifted option will eventually be worth less than its original value. For example, suppose the X stock described above grows in value to only $125 before the option expires. In that case the donee will eventually realize $25 from the gifted property yet the donor will have made a taxable gift of $30. Transferring options to a zeroed-out GRAT protects against this reverse leverage. If the stock fails to appreciate sufficiently, the option or the stock will be returned to the grantor with no gift tax cost and no impact on her adjusted taxable gifts.[62]

E. Using High Yielding Preferred Interests

Yields obtainable on preferred stock will often be significantly higher than the 7510 rate. As a result, a funding a GRAT with a safe, preferred stock will almost always be successful.

For those whose investment objectives do not include preferred stock investments, it should be possible to create an interest in a family investment partnership

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62 $P=\frac{A}{i}$ The U.S. Patent Office has issued a patent to Robert C. Slane for a method of establishing and managing grantor retained annuity trusts funded by nonqualified stock options, described more particularly as "An estate planning method for minimizing transfer tax liability with respect to the transfer of the value of stock options from a holder of stock options to a family member of the holder. The method comprises establishing a Grantor Retained Annuity Trust (GRAT) funded with nonqualified stock options. The method maximizes the transfer of wealth from the grantor of the GRAT to a family member by minimizing the amount of estate and gift taxes paid. By placing the options outside the grantor's estate, the method takes advantage of the appreciation of the options in said GRAT. In one embodiment the method also maximizes the amount transferred to the family member by keeping as many of the options as possible in the GRAT until immediately prior to the termination of the GRAT, when the grantor substitutes an equivalent value of assets into the GRAT for the remaining options, and then exercises the options. The method is used for evaluation purposes in establishing the GRAT, and responds to a variety of grantor-selected options. An Irrevocable Life Insurance Trust (ILIT) may also be established to provide life insurance should the grantor die before the termination of the GRAT. If the GRAT continues until its natural termination date the ILIT will receive the assets of said GRAT and may purchase further life insurance on the grantor." Patent # 6,567,790. On January 12, 2011, the director of the United States Patent and Trademark office began a reexamination of this patent.

$P=\frac{A}{i}$

or limited liability company that has the features of preferred stock. Consider the following example:

> **Example 8:** G transfers $5,000,000 worth of marketable securities to a family limited liability company (an "FLLC"). The FLLC has two classes of interest, a preferred interest and a growth interest. The preferred interest has a par value of $4,000,000 and carries a cumulative preferred return of 8%. It is redeemable in 20 years for its par value. The growth interest will receive the income of the FLLC not needed to fund the preferred return. G transfers the preferred interest to a 4-year GRAT at a time when the 7520 rate is 4%. The GRAT's annual annuity is $1,050,495, producing a zero taxable gift. The GRAT pays the annuity each year with preferred interests. In the final year, a cash supplement is needed. Assuming the value of the preferred interest remains constant Unless the investments in the FLLC lose more than 11% of their value over the 4-year period, the GRAT should return about 14% of its initial value to the remainder beneficiaries.

The downside of this approach is that it will not capture the investment return in excess of the amount needed for the preferred return for the remainder beneficiaries. This disadvantage can be overcome by the simultaneous creation and funding of another GRAT with the FLLC growth interests. If the FLLC's investment return is poor, it is likely that this GRAT will be unsuccessful. The FLLC growth interest will be returned to the grantor. If the FLLC's investment return exceeds the amount necessary to fund the preferred return, most of this excess will be paid to the remainder beneficiaries of the second GRAT.

Issues to consider before implementing this approach include:

1. §2701. Because the GRAT is expected to return the preferred interest to the grantor, care should be taken to make sure that the structure of the FLLC complies with the requirements of §2701.

2. Valuation. The initial valuation of the preferred and growth interests will be more complicated than the valuation of ordinary interests in FLLCs. Annual valuations will be needed to determine how much of the preferred and growth interests must be paid to the grantor.

3. <u>Possible Consolidation of Trusts</u>. The IRS might take the position that the two GRATs should be treated as one. The risk of this occurring could be mitigated by using GRATs with different provisions. For example, the duration of each GRAT could be different, and the remainder beneficiaries could be different trusts.

4. <u>Income Tax Issues</u>. Structuring the preferred interest as a guaranteed payment will maximize the chance of the GRAT's success. If the preferred payment is limited to income, the preferred interest technique will have the same degree of success as a GRAT funded with interests in single class LLC with the same assets unless the investment return is somewhere between the 7520 rate and the preferred rate of return. Using a guaranteed payment, however, will trigger additional income taxes in years when the FLLC's income is not sufficient to cover the required payments. As a result, it will generally be preferable to arrange for the owner of all of the membership interests for income tax purposes to be the grantor. If this approach is used, the FLLC will be disregarded for income tax purposes.

F. <u>Enhancing the Performance of a GRAT with Derivatives</u>

If a grantor transfers a marketable security to a GRAT, particularly a highly volatile stock, the possibility of success can be increased if the grantor purchases a call on the stock from the GRAT. Suppose, for example, that the grantor transfers $10,000,000 worth of a highly volatile marketable security to a 5-year GRAT. As discussed above, Rev. Proc. 98-34[63] establishes a safe harbor for valuing, for gift tax purposes, compensatory stock options that are exercisable to acquire publicly traded stock. The revenue procedure. provides that such options can be valued by using a generally recognized option model such as the Black-Scholes model or an accepted version of the binomial model. The Black-Scholes model would value a 5-year call, the exercise price of which is double the stock's current value, at about 60% of the market

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63 $P=\frac{A}{i}$ 1998-1 C.B. 983.

$P=\frac{A}{i}$

price of the stock if the stock is highly volatile.[64] Using Black-Scholes as a basis for establishing value, the grantor or her spouse could purchase from her GRAT the right to buy the $10,000,000 worth of stock at any time during the 5-year term of the GRAT for $20,000,000. She would pay $5,983,000 for the call. With the purchase price as part of its assets, unless the stock declines in value substantially, the GRAT will succeed in producing value at the end of its term for the remainder beneficiary. If, for example, the stock remains at its current level throughout the GRAT's term, at the end of the term, the GRAT will have assets for its remainder beneficiary worth about $5,700,000.

VI. MONITORING THE GRAT

A. In General

A GRAT's performance should be monitored in order to curtail losses generated by an unprofitable GRAT, to protect a profitable performance from erosion as a result of future investment losses and to protect a profitable performance from disappearance as a result of the premature death of the grantor.

B. Monitoring to Minimize the Impact of Investment Losses

A GRAT that underperforms in its initial years is unlikely to be a profitable GRAT. This is so because losses in the early years must be compensated for by better than average gains in the later years.

Suppose, for example, that G creates a 5-year GRAT in a month in which the § 7520 rate is 4.2%. She transfers property worth $1 million to it. She is entitled to receive an annuity of $225,900 at the end of each of the next 5 years. The actuarial value of the right to receive these annuity payments is $1 million. Suppose, the value of the property declined by 10% in each of the GRAT's first two years. It is now worth only $380,808, and will be required to make three more payments of $225,900 to the grantor. In order to produce any profit at all for the remainder beneficiary, the GRAT's

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64 $P=\frac{A}{i}$ Calculation provided by Lance Hall of FMV Opinions, Inc.

$$P=\frac{A}{i}$$

investments would have to grow in value by more than 35% per year in each of the next three years. Except in unusual circumstances, this is unlikely to happen.

When losses of this magnitude occur, the grantor should consider purchasing the GRAT's remaining assets and transferring them to a new GRAT. Because the GRAT is a grantor trust, the purchase can be accomplished without income tax cost. The grantor could pay the purchase price with a note, portions of which would be distributed to him over the remaining term of the GRAT.[65] With a fresh start, the property in the new GRAT would have a significantly better opportunity for producing a profit for the remainder beneficiary.

C. Monitoring to Protect Investment Gains

A GRAT that generates good investment performance in its initial years is likely to produce a profit for its remainder beneficiaries, but there is no guarantee that poor performance in later years will not substantially reduce its profitability. A GRAT's successful investment results can be locked in by one of two different transactions.

First, the grantor could purchase the GRAT's assets for a note. Because the GRAT is a grantor trust, the purchase can be accomplished without income tax cost. She could then transfer the assets to a new GRAT. If the interest rate on the note is equal to the § 7520 rate that was in effect when the GRAT was created, whatever profit has been generated prior to the sale will remain intact until the end of the GRAT term.

Second, the grantor could purchase the remainder interest from the remainder beneficiary. If the remainder beneficiary is a separate grantor trust treated as owned by the grantor, the purchase can be accomplished without income tax cost.

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[65] $P=\frac{A}{i}$ Treas. Reg. §25.2702-3(b)(1)(i)'s prohibition against the issuance of a note or other debt instrument in satisfaction of the annuity amount does not apply to notes issued by persons other than the GRAT itself. The IRS has ruled that the grantor's retained power, exercisable only in a fiduciary capacity, to reacquire GRAT assets by substituting property of equivalent value does not disqualify the grantor's retained interest under § 2702(b)(1).

$$P=\frac{A}{i}$$

Suppose, for example, that that G creates a 5-year GRAT in a month in which the § 7520 rate is 4.2%. She transfers property worth $1 million to it. She is entitled to receive an annuity payment of $225,900 at the end of each of the next 5 years. The actuarial value of the right to receive these annuity payments is $1 million. At the end of the 5-year term, the remaining GRAT property is to be paid to a separate grantor trust for the benefit of her children. Suppose, the value of the property increased by 20% in each of the GRAT's first two years. It is now worth $943,041, and will be required to make three more payments of $225,900 to the grantor. The net present value of the right to receive these payments is $624,495 (assuming a § 7520 rate of 4.2%). Therefore, the present value of the remainder interest is $318,545. The grantor could lock in the profit generated by the GRAT by purchasing the remainder interest from the separate grantor trust for $318,545. The grantor would then own all interests in the trust, the right to receive annuity payments and the right to receive the remainder at the end of the 5-year term. And the separate grantor trust would have cash of $318,545, the amount of which would not be affected by future investment performance of the GRAT assets.

D. <u>Monitoring to Protect Against Mortality Risk</u>

If a grantor dies while she has the right to receive further annuity payments from her GRAT, some portion, or all, of the GRAT will be included in her gross estate for federal estate tax purposes under § 2036. This section requires that a transferor include in her gross estate the value of property transferred during her life if she retained for life, or for a period that did not end before her death, the right to the income from the transferred property.

The grantor of a GRAT does not explicitly retain the right to income. Instead, she retains the right to an annuity which may be more or less than the actual income received by the trust. The IRS treats this type of retained interest as if it were the right to receive the income from a portion of the trust corpus. That portion is required to be included in the gross estate. The included portion is that fraction of the corpus which would be required to be invested at the § 7520 rate in effect on the date of the grantor's death to produce annual income equal to the required annuity payment.

The estate tax inclusion risk can be managed by using a separate grantor trust as the GRAT's remainder beneficiary and causing the grantor to purchase the remainder interest from the separate grantor trust at some time during its term after the performance of the GRAT's investments has caused the remainder interest to have significant value.

Suppose, for example, that a grantor established a 20-year GRAT using the annuity schedule set forth in Table 5 and funded it with an asset worth $1,000,000. At the end of the 20-year term, the remainder was to pass to a separate grantor trust. Suppose further that the asset increased in value by 20% per year over the first 5 years. At the end of the 5-year period, the GRAT assets would be worth about $2.4 million and the present value of the remainder interest (assuming a 4.2% § 7520 rate) would be about $1.2 million. The grantor could purchase the remainder interest from the separate grantor trust for $1.2 million. This purchase would eliminate the risk that the $1.2 million value that had accrued for the benefit of the remainder beneficiary would be subject to estate tax if the grantor died before the end of the 20-year term.

Alternatively, at the end of the 5-year period, the separate grantor trust could purchase the assets of the GRAT for a self-canceling installment note that would terminate on the death of the grantor with no further payments due. If the grantor died before the 20-year term of the GRAT had expired, no further payments would be due on the note, and little, if any, value would be included in the grantor's gross estate.[66]

VII. COMPARISON OF GRATS WITH OTHER TECHNIQUES

A. GRATs v. Outright Gifts

The gift is the only pure estate freezing technique. Once property is given away in a transaction complete for gift tax purposes, its value is forever frozen for estate and gift tax purposes at its date of gift value.

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66 $P=\frac{A}{i}$ Harrison, *Case Studies – Implementing Bright Ideas,* 38-19 Univ. of Miami Law Center on Estate Planning § 1902.4 (2004).

$P=\frac{A}{i}$

Nevertheless, the GRAT has the following potential advantages over an outright gift: (1) A GRAT can be structured to provide the possibility of a substantial shift of its future yield with only a nominal gift tax.[67] (2) A GRAT offers the possibility of minimizing valuation risk by use of a formula to define the retained interest. (3) A low taxable gift GRAT avoids the risk that gifted property might decline in value yet continue to be reflected in the grantor's adjusted taxable gifts at its original value. (4) If property is transferred to a GRAT in which the grantor's retained annuity is worth less than the value of the property transferred, and if it appreciates at a greater rate than the expected § 7520 rate, the GRAT will result in a shift of a greater amount than will the outright gift.

The first three advantages have already been discussed. The fourth merits further discussion. It can be illustrated by the following examples:

> **Example 9**: G transfers $1,000,000 worth of shares of the X Corp. to a GRAT the terms of which provide that she is to receive an annuity of $436,350 (43.635% of the original principal) for 2 years. At the end of the 2-year period, the trustee is to distribute the remaining trust property to her son, S. The value of G's annuity is $800,000. Her transfer to the GRAT will result in a taxable gift of $200,000.
>
> **Example 10:** G gives $200,000 worth of shares of the X Corp. to S.

In each of Examples 9 and 10, G will be treated as having made the same amount of taxable gift.

If the shares produce a total return over the two years equal to the § 7520 rate (which the examples assume to have been 6%), both fact patterns produce the same value for S. In each case, S will have assets worth $224,720 at the end of the 2-year

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67 $P=\frac{A}{i}$ While some individuals recognize there is an advantage to paying gift tax (*i.e.,* the gift taxes are removed from the transfer tax base if the individual lives for three years after the transfer), most, being generally of the opinion that the best tax is the one that can be deferred, are unwilling to do so.

$P=\frac{A}{i}$

period. The valuation assumptions have been fulfilled. S, in each case, is left with $200,000 plus an annual compounded return of 6%.

If the shares produce a total return over the two years in excess of the § 7520 rate, S will be better off with the GRAT. This is so because he will not only earn the return on the taxable gift portion of the GRAT (the $200,000) but will also earn a return on the non-gift portion (the $800,000) equal to the excess of the actual rate of return over the § 7520 rate. The GRAT creates leverage.

For example, assume that the rate of return for the 2-year period is 10%. At the end of the 2-year period, S will receive $267,909 from the GRAT. An outright gift would be worth only $242,000, the original $200,000 plus a 10% annual return.[68]

In contrast, if the shares produce a total return over the two years below the § 7520 rate, S will be better off with an outright gift. This is so because the gift portion of the under-productive GRAT will be used to fund the annuity. Despite the fact that S will receive less than the value that had been actuarially predicted, G's adjusted taxable gift base will continue to reflect a gift of $200,000. The leverage factor works here to hurt the remainder beneficiary. Of course, to the extent that the gift portion of the GRAT is low, as discussed above, the risk of reverse leverage virtually disappears.

B. <u>GRATs v. Sales</u>

A sale of an asset that the seller believes to have significant growth potential, can work as an estate freezing technique. If the purchaser lacks the funds to make the purchase, the purchase can be made for a note that is paid over an extended period of time. So long as the purchase price is equal to fair market value of the purchased property, and, if a note is used, the note bears the rate of interest required by§ 7872, no gift tax will be imposed on the sale. If the sale is to a trust that is treated as

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68 $P=\frac{A}{i}$ These calculations assume an income-tax free return. If income taxes are paid, the relative advantage of the GRAT is enhanced because income taxes will be paid by the annuitant, not by the remainder beneficiary.

$$P=\frac{A}{i}$$

wholly owned by the grantor under the grantor trust rules, the sale will not be an income tax recognition event.

A sale is not a perfect freeze because the transferor's estate will be increased by the investment return on the sale proceeds or by the interest received on the note if the sales price is paid with a note.

1. <u>Potential Advantages of a Sale Over a GRAT</u>

If the sale is made for a note, the interest rate required to be charged on a loan for a period of nine years or less will almost always be less than the § 7520 rate. This is so because the § 7520 rate is defined as 120% of the federal mid-term rate and because the federal short-term rate, as an economic matter, is generally less than 120% of the federal mid-term rate. In some cases, even the federal long-term rate will be less than the § 7520 rate. As of June, 2015, for example, the federal short-term rate was .43%, the federal mid-term rate, 1.6%, the federal long term rate, 2.5%, and the § 7520 rate, 2.0%.

Obviously a sale in exchange for a 2-year note at the June, 2015 federal short-term rate will leave the purchaser with more value at the end of the 2-year period than the remainder beneficiary of a 2-year GRAT would have if the asset purchased is the same as the asset transferred to the GRAT. This is so because the purchaser retains the actual return on the purchased property in excess of .43% while the remainder beneficiary of the GRAT retains only the actual return in excess of 2.0%. A 1% difference between the interest rate charged on the loan and the§ 7520 rate, for example, will increase the rate of return to the purchaser as compared to the rate of return to the GRAT remainder beneficiary by 2% over a two- year period and by 10.5% over a ten-year period.

The sale also has a generation-skipping transfer tax advantage. As discussed in Part IV. H., the GRAT is not an effective technique for shifting future income and appreciation to grandchildren because the termination of a GRAT in favor of a grandchild or a grandchild's trust (unless the trust is a non-skip person) would be a generation-skipping transfer tax event. The repayment of a loan by a grandchild or a grandchild's trust would not be.

The purchase for cash or note is a relatively simple transaction to structure and administer. Unlike the GRAT, there is no set of technical rules that must be followed in order to achieve qualification.

In the case of a purchase for a note, unlike the GRAT, regular payments on the note can be deferred until the end of the note. This can be particularly advantageous when the property to be transferred does not have a significant cash flow.

When the seller dies, the purchase price will be included in her gross estate either because she has already received it or because she owns the unpaid note representing the purchase price. When the grantor of a GRAT dies, if she has outlived the term of the GRAT, the amounts she received from the GRAT will be included in her gross estate. As discussed above, these amounts are likely to exceed the amounts received by the seller on any note she received in exchange for the sale. But, if the grantor of a GRAT dies before the end of the GRAT term, it is likely that the full value of any property remaining in the GRAT will be included in her gross estate.[69] As discussed below, however, the advantage of exclusion, in some cases, will be offset by the tax cost of the loss of basis adjustment under § 1014.

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69 $P=\frac{A}{i}$ See discussion in Appendix A.

$$P=\frac{A}{i}$$

2. Potential Advantages of GRAT Over a Sale

[a] Valuation Risk

A GRAT offers the possibility of minimizing valuation risk by use of a formula to define the retained interest. It may be possible to accomplish similar protection by using a formula to define the amount of the gift. But it is not certain that the IRS will ultimately concede that valuation clauses are valid.

There are two difficulties with using a formula definition clause.

- It is not clear that the use of this approach will be upheld by the courts for federal gift tax purposes. Because there is little doubt that the clause works for property transfer purposes, the invalidity for gift tax purposes will result in the transferor being treated as having made a taxable gift that she did not actually make.

Consider the following example:

> **Example 11:** G transferred a fraction of a 20% limited partnership interest in the X partnership to a trust for her daughter D. The numerator of the fraction is $1,000,000; the denominator of the fraction is the value of the transferred partnership interest as finally determined for federal gift tax purposes. The trustee paid a purchase price of $1,000,000 in cash. The IRS later successfully takes the position that the 20% interest is worth $1,500,000 but that the formula transfer clause is not effective for federal gift tax purposes. As a result, G will be treated as having made a taxable gift of $500,000 but will have transferred only 2/3rds of her 20% interest to D's trust.

- The use of a formula clause to define the portion of the property gifted rather than the amount of the consideration received (*i.e.*, the amount of the annuity, in the case of a GRAT) will reduce the value of the property passing to the purchaser.

Consider the following examples:

> **Example 12**: G transfers her 20% limited partnership interest in the X partnership to a 2-year GRAT for the benefit of a trust held for her daughter D. She believes

the interest is worth $1,000,000. The terms of the GRAT require that the GRAT pay her 54.54% of the initial value of the property at the end of each of the next two years. The § 7520 rate is 6%; the value of the annuity stream will be equal to the value of the interest transferred as finally determined for federal gift tax purposes. At the end of the first year, just before the annuity payment is due, the interest is sold for $2 million. The trustee pays the $545,400 annuity amount to G and invests the balance at 6%. At the end of the second year, the trustee pays G the $545,400 amount and pays the balance $996,400 to D's trust, subject to a refunding agreement if the GRAT trustee is required to pay a greater annuity amount.. Shortly thereafter, the IRS successfully takes the position that the transferred interest had a fair market value of $1,500,000. The appropriate annuity amount, therefore, was $818,155. The trustee of D's trust returns $545,437 to the GRAT to be used to pay the annuity amount owed. D's trust is left with $450,963.

Example 13: G transfers a fraction of her 20% limited partnership interest in the X partnership to D's trust. The numerator of the fraction is $1,000,000; the denominator of the fraction is the value of the transferred partnership interest as finally determined for federal gift tax purposes. The trustee paid a purchase price of $1,000,000 by delivering a two year note bearing interest at a rate of 5%. The note is payable at the end of a two year term. At the end of the first year, the interest is sold for $2,000,000. The trustee invests the proceeds at 6%. At the end of the second year, the trustee has $2,120,000. It pays principal and interest on the note of $1,102,500, leaving D's trust with $1,017,500. Shortly thereafter, the IRS successfully takes the position that the transferred interest had a fair market value of $1,500,000. Because the portion of the property transferred for property law purposes is a function of the finally determined gift tax value of the property, G has transferred only 2/3rds of her 2 0% interest. The trustee must return to G, 1/3rd of the purchase price or $666,666, plus the 5% investment return on the investment of the proceeds leaving only $317,501 for D's trust.

[b] <u>Economic Risk to Transferee</u>

The sale puts the transferee's assets at risk. The transferee, has paid the purchase price, which will not be returned in the event the purchased property declines rather than increases in value. In the case of a purchase for a note, the purchaser remains liable on the note whether or not the purchased property declines in value.

In the case of a purchase for a note, the economic risk could be reduced by arranging for the note obligation to be issued on non-recourse basis, secured by the acquired investment, or by making a loan to a trust that has few assets. This approach, however, runs some risk that the IRS might recharacterize the loan as a transfer of an interest in a trust or trust equivalent with a retained interest.[70] The retained interest would not meet the requirements of a qualified interest and, therefore, the entire loan could be a taxable gift.

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[70] $P=\frac{A}{i}$ The IRS has taken this position in at least one ruling. In PLR 9251004 (September 4, 1992), the IRS took the position that an individual's sale to a trust for a note left her with a retained right to receive trust income. In PLR 9436006 (March 14, 1994) the Service took the position that an individual's sale of property to a trust (of which the individual was the creator) for a note was not a transfer within the meaning of Code Sec. 2702.

In PLR 9515039 (January 17, 1995) the IRS concluded that a loan to a trust equivalent was not a transfer subject to a retained interest within the meaning of Code Sec. 2036, but only if the loan was guaranteed by a person with sufficient independent resources to enable her to pay the obligation if the trust equivalent defaulted.

Finally, in PLR 9535026 (June 2, 1995), the IRS decided that a debt obligation of a trust issued to a seller of property to the trust would not be treated as a term interest within the meaning of Code Sec. 2702. It conditioned its conclusion, however, by stating that the ruling would be void if "the promissory notes are subsequently determined to be equity or not debt." Referring to section 4.02(1) of Rev. Proc. 95-3, 1995-1 C.B. 385, the ruling states that it expresses no opinion about whether the notes would be treated as debt or equity because that determination is one of fact. The reference to section 4.02(1) of Rev. Proc. 95-3 is apparently a novel attempt to introduce the corporate debt-equity enigma into the trust arena. Code Sec. 385 suggests five factors that may be relevant in distinguishing corporate debt from corporate equity. Of the five factors, only one seems relevant to trusts -- the ratio of debt to equity (presumably, in the trust context, beneficial interests). Neither the Service nor the courts have established a rule of thumb for determining the property ratio. Bittker and Eustice, however, suggest that a " [it] is usually assumed . . . that a ratio of debt to equity that does not exceed 3 to 1 will withstand attack." Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders (6th Ed. 1994) 4-35.

$$P=\frac{A}{i}$$

To avoid the risk of having the IRS characterize a sale for a note to a trust as a transfer to the trust with a retained interest, most advisors recommend that the trust be funded with assets worth at least ten percent of the after-purchase value of the trust net of the obligation on the note. These are the assets that are at risk in the sale to a trust for a note.

[c] Basis and Mortality Issues

Property that is sold to a grantor trust, for cash or for a note has a carry over basis. Its basis in the hands of its purchaser is the same as its basis in the hands of the transferor.

If the grantor of a GRAT dies before the GRAT term is completed, a major portion, if not all, of the GRAT property will be included in her gross estate. If this occurs, the property will receive a basis under § 1014 equal to the estate tax value of the GRAT property.

If the transferor of a sale to a grantor trust for a note dies before the note is paid off, the tax treatment of the transaction at death is not clear. It is possible that death, which terminates grantor trust status, would be treated as a recognition event under the general rule that treats the termination of grantor trust status as a transfer.[71] Although this result could cause liquidity issues for the transferor's estate, it would not be a terrible result. The income taxes due as a result of the recognition would be deductible for estate tax purposes, and the purchaser would receive a basis in the asset equal to the purchase price.

The rule treating the termination of grantor trust status as a transfer has not been applied to a termination caused by death. If death is not a recognition event, what happens to the basis of the note? Because the note is included in the transferor's gross estate, it should receive a basis equal to its estate tax value under § 1014. It should not be

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[71] $P=\frac{A}{i}$ *Madorin v. Commissioner,* 84 T.C. 667; Treas. Reg. § 1.1001-2(c).

$P=\frac{A}{i}$

treated as an item of income in respect of a decedent under § 691, the basis of which is not adjusted under § 1014,[72] because § 691 applies to items of income that would have been taxed to the decedent if she had lived. If the transferor had lived, the note payments would not have been included in her gross estate because of the grantor trust status of the payor. But the basis in the asset that was sold to the grantor trust remains the same as it was prior to the transferor's death.[73]

If the basis of an asset sold to a grantor trust is low enough and the post-sale appreciation not high enough, it is possible that the loss of basis adjustment at death will produce higher taxes for the purchaser than would estate tax inclusion of the transferred property. This can occur because, the consideration paid will be subject to estate tax and a portion of the purchased asset will, when sold, be subject to income tax. This double tax effect cannot occur with a GRAT.

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[72] $P=\frac{A}{i}$ § 1014(c).

$P=\frac{A}{i}$

[73] $P=\frac{A}{i}$ For a detailed discussion of this issue, see Manning and Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Mgmt. Est., Gifts & Tr. J. 3 (1999).

$P=\frac{A}{i}$

Consider the following examples:

> **Example 14**: G transferred her limited partnership interest in the X partnership to a trust for her daughter D. The interest had a basis of zero and a fair market value of $1,000,000. D's trust gave her a note for the purchase price. G died one year later when the partnership interest was worth $1,250,000. The note attracted an estate tax of $450,000 calculated at a 45% rate.[74] G's will gave the note (net of estate tax) to D's trust). Shortly thereafter, the trust sold the partnership interest for $1,250,000 and paid income tax on the sale of $187,500. D's trust was left with $612,500.

> **Example 15**: G transferred her limited partnership interest in the X partnership to a trust to a two-year GRAT, the remainder beneficiary of which was D. Right before the first GRAT payment was due, G died. The partnership interest was then worth $1,250,000, all of which was included in G's gross estate. G's Will gave her remaining GRAT payments to D's trust. Estate taxes of $562,500, calculated at a 45% rate, were paid, leaving $687,500 for D's trust, $75,000 more than it would have had if she had used the sale technique.

It is possible to calculate, by using the formula set forth below, the amount of appreciation that is necessary to occur with respect to a transferred asset in order that the estate tax savings that occur by reason of protecting the transferred property from estate tax will exceed the income tax disadvantage of the loss of the basis adjustment. In the formula,

X = the unknown, the necessary % of appreciation.
V = the fair market value of the asset at the time of transfer.
B = the basis of the transferred asset.
I = the income tax rate on long term capital gains.
E = the estate tax rate.
V+VX-E(V+VX) = V+VX-(I(V+VX)-EV+IB

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[74] $P=\frac{A}{i}$ To simplify the example, interest on the note has been ignored.

$P=\frac{A}{i}$

Applying this formula to the facts in Examples 14 and 15tells us that X is 50%. At any rate of appreciation, less than 50%, the income tax on sale will be more than the estate tax savings attributable to protecting post-sale gain from estate tax.

3. Combining the Advantages of a Sale for a Note With a GRAT With a Leveraged GRAT

If the property transferred to a GRAT is property that is subject to a debt, the GRAT will enjoy, in part, the advantages of the lower interest rate payable on the note as well as the ability to defer a substantial portion of the required payments until the end of the GRAT term.

Suppose, for example, that G owns $1 million worth of marketable securities. She forms a single member LLC and contributes $100,000 worth of the securities to the LLC. She then sells the remaining securities to the LLC for a $900,000 3-year note with an interest rate of .41%. Interest is to accrue on the note and be paid at the end of the three year period. She transfers her interest in the LLC to a 3-year GRAT and retains the right to receive a $34,675 annuity payment at the end of each of the 3 years. The present value of the right to receive these annuity payments, using the section 7520 rate of 2%, is $100,000, the value of the LLC interest transferred to the GRAT. Suppose the funds in the LLC were invested to produce a 10% annual return over the 3-year period. The Chart below shows how this GRAT would perform:

Gross Value of LLC Assets	Debt	Net Value of LLC Assets	Investment Return @ 10%	Annuity Payment	Interest On Debt
$ 1,000,000	$ 900,000	$ 100,000	$ 100,000	$ 34,675	$ 3,690
$ 1,065,325	$ 903,690	$ 161,635	$ 100,000	$ 34,675	$ 3,705
$ 1,130,649	$ 907,395	$ 223,254	$ 100,000	$ 34,675	$ 3,720
$ 1,195,974	$ 911,115	**$ 284,858**			

At the end of the three year term, the remainder beneficiaries would have assets worth $248,858. If G had instead used a conventional, unleveraged GRAT, here's how it would perform:

Value of GRAT Assets	Investment Return @ 10%	Annuity Payment
1,000,00	100,000	346,755
753,245	75,325	346,755
481,815	48,182	346,755
183,242		

At the end of the 3-year term the remainder beneficiaries would have assets worth only $188,242.

C. GRATs v. § 2701 Transactions

The term "§ 2701 transaction" as used here refers to a recapitalization of a partnership or corporation in order to issue two classes of equity interest. One class receives or has the right to receive a fixed return. The other represents the residual or "growth" interest. Generally, the senior family members, who are trying to minimize future estate tax liability, receive or retain the fixed income securities and the junior family members receive the residual interest.

The rules governing § 2701 transactions are complex and are beyond the scope of this paper.[75] There are, however, two aspects of a § 2701 transaction that put it at a disadvantage when compared with GRATs.

First, in a § 2701 transaction, the junior interest is given a minimum value of at least 10% of the value of the entity as a whole.[76] In order to put this value in the hands of the junior family members, the original owner either makes a gift or sells the

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75 $P=\frac{A}{i}$ § 2701.

$$P=\frac{A}{i}$$

interest to them. In either event, at the outset of the transaction there is real value in the hands of the junior family members that may be lost if the investment does not produce the expected return. The GRAT does not create this risk since it can be created with a nominal initial interest in the hands of the remainder beneficiary.

Second, the junior interest in a § 2701 transaction is valued by subtracting the market value of the senior interest from the value of the entity as a whole. The balance, after adjusting for various discounts (such as the discount for minority interest or lack of marketability) is assigned to the junior interest. The market value of the senior interest is established with reference to actual market conditions. There is no rate table available to permit a mechanical calculation of value. It is likely that the market would demand a much higher return on a senior equity interest in a closely held family business or investment company than the § 7520 rate. As a result, less of the future profits of the entity will pass to the junior family members than would be the case if the GRAT technique had been used instead.

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[76] $P=\frac{A}{i}$ § 2701(a)(4).

$$P=\frac{A}{i}$$

APPENDIX A

ESTATE TAX TREATMENT OF GRAT WHEN GRANTOR DIES BEFORE THE ANNUITY TERM ENDS.

§ 2036

If a grantor dies while she has the right to receive further annuity payments from her GRAT, some portion, or all, of the GRAT will be included in her gross estate for federal estate tax purposes under § 2036. This section requires that a transferor include in her gross estate the value of property transferred during her life if she retained for life, or for a period that did not end before her death, the right to the income from the transferred property.

The grantor of a GRAT does not explicitly retain the right to income. Instead, she retains the right to an annuity which may be more or less than the actual income received by the trust. The IRS treats this type of retained interest as if it were the right to receive the income from a portion of the trust corpus. That portion is required to be included in the gross estate. The included portion is that fraction of the corpus which would be required to be invested at the § 7520 rate in effect on the date of the grantor's death to produce annual income equal to the required annuity payment.[77]

Consider the following example:

> **Example**: G transferred $1,000,000 to a GRAT to pay him an annuity of $100,000 per year for the lesser of 10 years or his remaining lifetime. At the end of the trust

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[77] $P=\frac{A}{i}$ "The portion of the trust's corpus includible in the decedent's gross estate for Federal estate tax purposes is that portion of the trust corpus necessary to yield the decedent's retained use or retained annuity, unitrust, other income payment as determined in accordance with section 20.2031-7 (or section 20.2031-7A, if applicable)." Prop. Treas. Reg. § 20.2036-1(c)(2); Rev. Rul. 82-105, 1982-1 C.B. 133.

The formula for calculating the portion of the principal to be included is as follows:

$$P=\frac{A}{i}$$

In this formula, "A" equals the annuity amount, "i" equals the § 7520 rate, and "P" equals the portion of the trust principal to be included.

> period, the trust property was to be distributed to G's son S. G died at the beginning of the 6th month during the 9th year when the trust was worth $2,000,000 and the § 7520 rate was 10%. G's estate will be required to include $1,000,000 in his gross estate because $1,000,000 would be required to be invested at 10% to produce income equal to the $100,000 annuity.

If a GRAT is established by joint contributions made by the beneficiary of the annuity interest and by the beneficiary of the remainder, and if each has contributed an amount equal to the actuarial value of her interest in the trust, § 2036 ought not to apply on the death of the annuitant. Section 2036 applies only if the decedent has not received adequate and full consideration in money or money's worth for her transfer.

In Private Letter Ruling 9515039,[78] the IRS determined that § 2036 did not apply in the case of such a joint purchase when the obligation to pay the annuity was guaranteed by the holder of the remainder interest who had sufficient assets, independent of her interest in the jointly purchased property, to satisfy the annuity. The IRS cited Rev. Rul. 77-193[79] in support of its conclusion. In that ruling, the IRS had concluded that § 2036 did not apply to a transfer of property in exchange for the personal obligation of a transferee that could not be satisfied solely out of the transferred property and the amount of which was not determined by the size of the income generated by the transferred property. In the absence of such a guarantee, however, the IRS may have characterized the annuity as a retained interest in property transferred by the decedent.

§ 2033

If the grantor has the right to receive annuity payments after her death, the correct measure of inclusion in her gross estate is unclear. Suppose, for example, that G, the grantor described in the example above, had retained the right to receive $100,000 per year for 10 years, whether or not he lived for 10 years. Suppose further that on the date of his death, the actuarial value of his right to receive the last annuity payment was

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[78] $P=\frac{A}{i}$ $P=\frac{A}{i}$ PLR 9515039 (January 17, 1995).

[79] $P=\frac{A}{i}$ $P=\frac{A}{i}$ Rev. Rul. 77-193, 1977-1 C.B. 273.

$95,346. The value of the final annuity payment should be included in his gross estate under § 2033. To what extent does the inclusion of a portion of the trust under § 2033 affect the amount of the inclusion under § 2036?

Three are at least three possible approaches. First, the inclusion could be the sum of the two amounts, in this case, $1,095,346. This approach seems clearly inappropriate because it could produce an inclusion amount that exceeds the value of the trust assets. This would be true, for example, if G's trust had been worth only $1,000,000 at his death rather than $2,000,000.

The second approach is to determine which portion of the trust each section includes and to adjust for any double counting. In the example, one-half of the principal of the trust is required to be included under § 2036 because G is deemed to have retained the right to the income from one-half of the principal. Because the final annuity payment, which is required to be included under § 2044 could be made from either half of the trust, arguably, it should result in an additional inclusion of only half of the $95,346 or $47,673.

Finally, the inclusion could be limited to the amount included under § 2036. This approach would be justified on the basis that the amount included under § 2033 could be funded entirely out of the portion of the trust included under § 2036. Regulations that became final effective November 8, 2011 concludes as follows:

> If section 2036 applies to an interest retained by the decedent in a trust or otherwise and the terms of the trust or other governing instrument provide that, after the decedent's death, payments the decedent was receiving during life are to continue to be made to the decedent's estate for a specified period (as opposed to payments that were payable to the decedent prior to the decedent's death but were not actually paid until after the decedent's death), such payments that become payable after the decedent's death are not includible in the decedent's gross estate under section 2033 because they are properly reflected in the value of the trust corpus included under this section..[80]

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80 $P=\frac{A}{i}$ $P=\frac{A}{i}$ Treas. Reg. § 20-2036-1(c)(1)(i), T.D. 9555 (November 7, 2011), applicable to the estates of decedents who die on or after November 8, 2011.

§ 2039

This section requires inclusion of the value of an annuity or other payment receivable by any beneficiary by reason of surviving the deceased annuitant under a contract or other agreement under which an annuity or other payment was payable to the decedent. Regulations that became final effective July 14, 2008 conclude that the retention of an annuity interest in a trust will not result in inclusion in the grantor's gross estate under § 2039.[81]

Previous letter rulings had reached a contrary conclusion. In a number of earlier private letter rulings the IRS took the position that the gross estate of a decedent who died before the termination of her right to receive an annuity from a GRAT must include the full value of the trust corpus under § 2039(a).[82]

The IRS's application of § 2039 to an annuity paid under a trust instrument of which the decedent is the grantor or settlor was of questionable validity. § 2039 appears to require a "purchase" of an annuity rather than a transfer subject to a retained interest. For this reason, § 2039(b), which describes the amount includible, limits the includible amount to the amount of the survivor's annuity (or other amount) proportionate to the amount of the "purchase price" contributed by the decedent. A grantor who transfers property to a trust in which she retains an annuity interest does not pay a purchase price for the annuity.

The use of the purchase price as the mechanism for determining the amount of inclusion suggests the necessity of a commercial or buyer-seller relationship between the decedent and the person making her annuity payments, a relationship that does not exist between the grantor of a GRAT and her trustee. The legislative history § 2039, which was added to the Code in 1954, suggests that it was intended to codify the

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[81] $P=\frac{A}{i}$ $P=\frac{A}{i}$ Treas. Reg. § 20-2039-1(e)(1), T.D. 9414 (July 11, 2008).

[82] $P=\frac{A}{i}$ $P=\frac{A}{i}$ PLR 20021009 (November 19, 2001); FSA 200036012 (September 8, 2000); PLR 9451056 (September 26, 1994); PLR 9448018 (August 30, 1994); PLR 9345035 (August 13, 1993). The IRS had earlier reached a similar result in a private letter ruling dealing with a charitable remainder unitrust. PLR 8321104 (February 24, 1983).

inclusion rule applicable to joint and survivor annuities purchased by a decedent that had developed under existing case law[83] and to extend it to certain annuities purchased for a decedent by her employer.[84] The transferor to a GRAT is not buying an annuity from her trust. She is simply making a transfer of property and retaining an interest in that property. The trustee assumes no personal obligation to make the required annuity payments to the transferor. If the trust assets are insufficient to make payment, the transferor has no claim against the trustee other than possibly a claim based on a charge of imprudent management of trust assets.[85]

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83 $P=\frac{A}{i}$ $P=\frac{A}{i}$ *See Commissioner v. Clise*, 122 F.2d 998 (9th Cir. 1941).

84 $P=\frac{A}{i}$ $P=\frac{A}{i}$ *See* S. Rep. No. 1622, 83rd Cong. 2d Sess. 123-124 and 470-472 (June 18, 1954).

85 $P=\frac{A}{i}$ $P=\frac{A}{i}$ *Cf. Ray v. United States*, 762 F.2d 1361 (9th Cir. 1985); *LaFargue v. United States*, 689 F.2d 845 (9th Cir. 1982); *Estate of Fabric v. Commissioner*, 83 T.C. 932 (1984).

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