

THE DESIGN, FUNDING, ADMINISTRATION REPORTING & REPAIR OF GRATS & QPRTS

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Estate Tax Exemption and Income/Gift Estate Tax Rates

Year	Exemption Equivalent	Rate	Annual Exclusion
2009	\$ 3,500,000	45%	\$13,000
2010	None	35%	\$13,000
2011	\$ 5,000,000	35%	\$13,000
2012	\$ 5,120,000	35%	\$13,000
2013	\$ 5,250,000	40%	\$14,000
2014	\$ 5,340,000	40%	\$14,000
2015	\$ 5,430,000	40%	\$14,000
2016	\$ 5,450,000	40%	\$14,000
2017	\$ 5,490,000	40%	\$15,000
2018	\$11,180,000	40%	\$15,000

Federal Income Tax Rates: 2017 vs. 2018

Income Taxes	2017	2018
Income tax rates	Maximum rate of 39.6% (or 43.4% with health care surtax) (15%, 28%, 31%, 36% and 39.6% brackets)	Maximum rate of 37% (or 40.6% with health care surtax) (10%, 12%, 22%, 24%, 32%, 35% and 37% income tax brackets)
Dividends	Ordinary income treatment (taxed at rates listed above)	Ordinary income treatment (taxed at rates listed above)
Long-term capital gains	20% (or 23.8% with health care surtax)	0% for taxpayers under 25% bracket 15% for taxpayers in 25%, 32% and 35% brackets 20% if in 37% bracket (or 23.8% with health care surtax)
Health care surtax	3.8% on lesser of (i) net investment income; or (ii) excess of modified adjusted gross income over the "threshold amount" (\$250,000 for married couple; \$200,000 for individual taxpayers)	3.8% on lesser of (i) net investment income; or (ii) excess of modified adjusted gross income over the "threshold amount" (\$250,000 for married couple; \$200,000 for individual taxpayers)

Basic Features of a GRAT

- Grantor Retained Annuity Trusts (“GRAT”) have become an integral part of estate plans for high net worth clients.
- A GRAT allows you to transfer all appreciation over the Section 7520 interest rate to children or other beneficiaries gift tax free.
- The 2018 7520 rate is 3.4% (This rate has fluctuated between 1% and 3% over the previous five years).
- GRATs can be structured with a term of as little as two years.
- GRATs can be established on a zeroed-out basis (using less than \$1 of the grantor’s gift tax exemption to shift all growth of the GRAT assets in excess of the Section 7520 rate to GRAT beneficiaries at the end of the GRAT term).

Rolling GRATs

- The Grantor of a GRAT must survive the term of the GRAT to be effective.
- “Rolling GRATs” – a popular technique using the minimum two-year term permitted and “rolling over” the first year GRAT annuity payment to a new two year GRAT.
 - There are two GRATs to administer in year 2 of a rolling two year GRAT plan.
 - This concept allows clients to capture significant gains in GRAT assets realized over a short term and hedge against volatility in the markets.

GRATs – An Introduction (continued)

- **Implementation:** GRATs are statutory creatures permitted under the Internal Revenue Code. A properly drafted and executed GRAT must be funded on a single date and be issued a taxpayer identification number.
- **Administration:** Proper administration of a GRAT is also very important. Annuity payments must be made on a timely basis. Tax compliance must be met in the form of gift tax reporting and the filing of annual grantor trust tax returns.
- **Sale to Grantor Trust:** This outline will also briefly discuss and compare the use of a sale to a grantor trust as an alternative approach to GRATs.

Applicable Federal Interest Rates

August 2018	Term of Loan	Interest Rate
Short-term loan	Under 3 years	2.42%
Mid-term loan	3-9 years	2.80%
Long-term loan	Over 9 years	2.95%

August 2018 Section 7520 Rate: 3.40%

GRATs in General

Definition: A GRAT is an irrevocable trust in which the grantor retains the right to receive fixed annuity payments that are payable at least annually and for a term of two or more years. At the end of the GRAT term, the remaining principal is distributed outright, or in trust for, the remainder beneficiaries (usually the grantor's children.)

- (i) **If the grantor survives the GRAT term:** The remaining GRAT assets are excluded from the grantor's estate for federal gift and estate tax purposes.
- (ii) **If the grantor fails to survive the GRAT term:** The GRAT assets are included in the grantor's gross estate under IRC Sections 2036 or 2039.

Gift/Estate Tax Consequences of GRATs

- **Taxable Gift**: The amount of the taxable gift is the difference between the fair market value of the property transferred by the grantor to the GRAT less the value of the interest retained by the grantor.
- **Application of IRC Section 2702**:
 - **“Applicable Family Member”**: The value of an interest in trust transferred to an applicable family member is determined under IRC Section 2702.
 - The interest retained by grantor that is a “qualified interest” is valued under the 7520 tables; any interest retained by the grantor that is not a qualified interest is valued at zero.
 - If GRAT assets generate return in excess of 7520 rate, the excess growth passes to the GRAT beneficiaries at the end of the GRAT term free of gift tax.
 - **Planning Note**: Avoid using a GRAT payout period of less than annually.

Gift/Estate Tax Consequences of GRATs (continued)

- **Remainder & Reversionary Interests**: The grantor may retain a reversionary interest in a GRAT.
 - The GRAT provides that if the grantor fails to survive the GRAT term, the GRAT terminates and the grantor's estate receives back the GRAT property (causing the property to pass under his or her will or revocable trust). By failing to survive the term, the entire trust property may be included in the grantor's gross estate.
 - By retaining a reversionary interest and causing the GRAT property to pass under the grantor's will or rev. trust, it may be possible to defer or eliminate estate tax through the use of the marital and charitable deduction.
- **Estate Inclusion**: IRC Sections 2033 and 2036 apply to a GRAT where the grantor does not survive the GRAT term.

7520 Rate Fluctuation - May 2007 - May 2018

- **Use of Short Term GRATs:** There are a number of factors to consider in determining whether to use a short or longer term GRAT, including reduced mortality risk, reduced investment risk, interest rate risk, and asset liquidity. The May 2018 7520 rate was 3.2% (3.4% this month).

Month	§ 7520 Rate	Month	§ 7520 Rate
May 2018	3.2%	May 2012	1.6%
May 2017	1.8%	May 2011	3.0%
May 2016	1.8%	May 2010	3.4%
May 2015	1.2%	May 2009	2.4%
May 2014	2.4%	May 2008	3.2%
May 2013	1.2%	May 2007	5.6%

Example 1: Tesla 2-Year GRAT

Elon Musk transfers 100,000 shares of Tesla Motors to a 2-year GRAT on 3/1/12. Tesla traded at \$34 per share. The fair market value of the transfer to the 2012 GRAT was \$3,400,00. The March 2012 AFR was 1.4%. The GRAT was structured to pay 51.05166% of the initial GRAT value to Elon on an annual basis for two years. The annuity payment is \$1,735,756.

Year 1: Tesla did not appreciate in value from over the first GRAT year ending 3/1/13. The GRAT distributed 51,052 shares of Tesla to Elon in satisfaction of the required first year annuity payment. There were 48,948 shares of Tesla remaining in the 2012 GRAT.

Example 1: Tesla 2-Year GRAT

Elon Musk transfers 100,000 shares of Tesla Motors to a 2-year GRAT on 3/1/12. Tesla traded at \$34 per share. The fair market value of the transfer to the 2012 GRAT was \$3,400,00. The March 2012 AFR was 1.4%. The GRAT was structured to pay 51.05166% of the initial GRAT value to Elon on an annual basis for two years. The annuity payment is \$1,735,756.

Year 2: Tesla increased in value from \$34 per share to \$250 over the second GRAT year. Elon received a second annuity distribution of 6,943 shares of Tesla (the required \$1,735,756 GRAT payment). The remaining 42,005 shares of Tesla (valued at \$10,501,250) pass to the Musk children free of gift tax.

The amount of gift tax exemption used to transfer \$10,501,200 without gift tax was only \$0.54 (**yes, 54 cents**)

Example 2: S&P 500 Total Return Fund 2-Year GRAT

Joe Index transfers 1,000 shares of an S&P 500 Total Return Fund to a 2-year GRAT on 1/1/13. The S&P 500 traded at \$2,504 per share. The January 2013 AFR was 1.0%. The GRAT was structured to pay 50.75111% of the initial GRAT value to Joe on an annual basis for two years. The annual annuity payment is \$1,270,800.

Year 1: The S&P Fund appreciated in value by 32.39% from \$2,504,000 to \$3,315,000 over the first GRAT year ending 12/31/13. The GRAT distributed 383 shares of the S&P 500 Index Fund to Joe in satisfaction of the required first year \$1,270,800 annuity payment. There were 617 shares of the S&P 500 Index remaining in the 2012 GRAT.

Example 2: S&P 500 Total Return Fund 2-Year GRAT

Year 2: The S&P 500 Total Return Fund increased in value from \$3,305 to \$3,769 over the second GRAT year. Joe received a second annuity distribution of 337 shares of the S&P 500 Total Return Fund (the required \$1,270,800 GRAT payment). The remaining 280 shares of the S&P 500 Index Fund (valued at \$1,055,000) pass to the Taxpayer children free of gift tax.

The amount of gift tax exemption used to transfer \$1,055,000 without gift tax was only \$0.33.

Rolling Two Year GRATs

- **Minimum GRAT Term:** GRATs are permitted to have a term as short as two years.
- **Annual GRATs:** Clients establish a rolling two year GRAT program, “rolling over” the first year annuity payment to a new two year GRAT.
 - These clients would have one GRAT in year one and two separate two year GRATs beginning in year two.
 - This approach captures the volatility of a stock or fund holding.

Example 3: Rolling 2-Year Tesla GRATs

A rolling two year GRAT allowed Elon Musk to transfer the full appreciation of the Tesla stock transferred to his 2012 GRAT.

Year 1: Tesla did not increase in value in year one. Elon received 51,052 shares of Tesla worth \$1,735,756 as his initial year GRAT annuity payment.

If Elon contributed the 51,052 shares to a 2013 GRAT under a rolling two year GRAT program, the \$1,735,756 would have appreciated to \$12,763,000 from 3/1/13 to 3/1/14.

- The required 3/1/14 first year annuity payment from the new 2013 GRAT would have been \$1,735,756.
- Likewise, the second year payment due 3/1/15 would also be \$1,735,756.
- The \$9,141,488 (adjusted by investment gain/loss in the second year GRAT) passes gift tax free to the Musk children.

Escalating GRAT Annuity Payments

- **Level or Escalating Payments:** GRAT payments can be made equally over the term of the GRAT or increasing at a rate of 120% per year.
- **Escalating GRAT Percentages Under 2012 Tesla GRAT Example:** Using the March 2012 Tesla GRAT example, the annual GRAT payments can range from:
 - 51.05166% annually for two years; or
 - 46.44034% in year 1 and 55.72840% in year 2.

Example 4: Tesla Escalating 2-Year GRAT

Elon Musk transfers 100,000 shares of Tesla Motors worth \$3,400,000 to an escalating 2-year GRAT on 3/1/12. The GRAT was structured to pay Elon (1) 46.44034% of the initial GRAT value in year one and (2) 55.72840% of the initial GRAT value in year two.

Year 1: The annual annuity payment in year one is \$1,579,000. Tesla did not appreciate in value from over the first GRAT year ending 3/1/13. The GRAT distributed 46,441 shares of Tesla to Elon in satisfaction of the required first year annuity payment. There were 53,559 shares of Tesla remaining in the 2012 GRAT.

Example 4: Tesla Escalating 2-Year GRAT

Elon Musk transfers 100,000 shares of Tesla Motors worth \$3,400,000 to an escalating 2-Year GRAT on 3/1/12. The GRAT was structured to pay Elon (1) 46.44034% of the initial GRAT value in year one and (2) 55.72840% of the initial GRAT value in year two.

Year 2: Tesla increased in value from \$34 per share to \$250 over the second GRAT year. Elon received a second annuity distribution of 7,579 shares of Tesla (the required \$1,894,766 GRAT payment). The remaining 45,980 shares of Tesla (valued at \$11,495,000) pass to the Musk children free of gift tax.

- The Escalating 2-Year GRAT transferred **an additional \$993,750** to the Musk children free of gift tax as compared to a 2 year GRAT with level payments.
- The amount of gift tax exemption used to transfer \$11,495,000 without gift tax remains at \$0.54.

GRAT Prohibitions

- **Restrictions in GRAT Agreement:** The GRAT agreement must prohibit the following actions:
 - Additional contributions to the GRAT;
 - Prepayment of the annuity interest to the grantor (“commutation”);
 - Use of a promissory note or similar financial arrangement to satisfy the annuity payment obligation;
 - Payments to any person other than the grantor/annuitant before the expiration of the GRAT term.
- A GRAT *is* permitted to return an amount greater than the required annuity payment to the grantor if stated in the GRAT agreement. (However, this runs counter to the goal of the GRAT.)
- The GRAT agreement should have a provision adjusting the annuity payment if an error was made by the trustee.

GRAT Income Tax Rules

Grantor Trust: A GRAT is a grantor trust for income tax purposes:

- May hold subchapter S stock.
- No gain/loss recognized on transactions between grantor and the GRAT.

Tax Reporting/Effect: All items of GRAT income, deduction, losses & credits are reported by the grantor on her individual income tax return.

Qualification as a Grantor Trust: A GRAT is a grantor trust if either:

- The annuity interest retained by the grantor is at least 5% of the value of the GRAT assets (which is almost always the case); or
- The grantor retained one of the other enumerated powers specified in IRC Sections 671-679.
- GRATs often state that the grantor has the right to swap assets of equivalent value, qualifying the GRAT as a grantor trust under IRC 675(4).

Carryover Basis: Although GRATs can be effective in transferring assets gift tax free to children, the cost basis of the assets will not be “stepped up” at the grantor’s death.

Example 5: Payment of Capital Gain Tax in Tesla 2-Year GRAT

Elon Musk transferred \$3,400,000 worth of Tesla Motors to a 2-year GRAT on 3/1/12. The GRAT resulted in 42,005 shares of Tesla stock worth \$10,501,250 passing to the Musk children free of gift tax. Elon has a nominal \$12 cost basis in the Tesla stock. If Elon elects to sell the stock just prior to the expiration of the GRAT term, he would realize \$10,000,000 of capital gains and pay \$2,000,000 of tax.

- The 20% capital gain tax should be applied to this sale
- The special 3.8% additional Affordable Care Act surtax is not imposed on an active participant in a business

The amount of gift tax exemption used to transfer \$10,501,200 was only 54 cents.

GRAT Income Tax Reporting

- **Tax Reporting Requirement:** Grantor trusts are subject to the same tax reporting requirements as other trusts.
- **Alternate Methods of Reporting.** There are two general methods of trust reporting:
 - **Traditional Method:** The trust obtains a taxpayer ID #; all items of income, deduction and credit of the trust are reported on a separate form attached to Form 1041 naming the grantor as the owner of these items.
 - **Payor Notice Method:** The trust can use the grantor's social security number and need not obtain a trust taxpayer identification number.
 1. The trustee must send to the payor a statement showing the name and social security number of the grantor;
 2. The trustee must give the owner a statement showing (a) all items of income, deduction and credit of the trust for the tax year; (b) the payor of each item; and (c) notice that the income must be included in the grantor's taxable income for the year.
 3. The trustee must obtain a Form W-9 from the grantor.

Improper GRAT Administration

- **Funding of GRAT on Different Dates:** A GRAT can be funded only on one date and GRATs cannot receive additional contributions after initial funding.
 - **Possible Solution:** Treat funding as if multiple GRATs were created on the same date, document the second transfer as a loan by the grantor to the GRAT, and refunding of any improper contributions to the grantor.
- **Change in IRC Section 7520 Rate:** Funding may occur in a later month than first intended – use a savings clause provision to adjust the annuity payout rate accordingly.

Improper GRAT Administration

Trustee Fails to Make Timely GRAT Payments: Annuity payments are due within 105 days of the GRAT anniversary date – use the funding date as the anniversary date, not the date the GRAT is executed.

Grantor Fails to Report the GRAT Funding on a Gift Tax Return: GRAT transfers must be reported on a gift tax return filed April 15 of the following year (unless extended).

- Filing of the gift tax return starts the statute of limitations
 1. Generally three years.
 2. Six years if substantial undervaluation of assets.
 3. Gift tax return may be filed late.
- Adequate disclosure rules are applicable.

Planning Issues with Illiquid GRATs

- **Selection of Term**: Choose a term beyond the expected liquidity event date.
- **Backloading**: Backload the GRAT by using the 20% annual escalating annuity payment structure.
- **Partial Liquid GRAT Funding**: Fund the escalating GRAT with some liquid assets to facilitate the required GRAT payments in early years.

Immunization of GRAT Assets

- Grantor Option to Immunize – The grantor has the option to “immunize” the GRAT at any time during the GRAT term.
- Immunization serves to freeze the GRAT gain prior to the expiration of the GRAT term.
- Immunization can also be used to withdraw assets which have declined appreciably.
 - In both cases, the immunized assets can be used to “re-GRAT” beginning a new GRAT term.
 - No clear authority that “re-GRATing” is permitted by the Internal Revenue Service.
 - Likewise, there is no authority which prohibits “re-GRATing.”
- Immunization can be accomplished by substitution of other assets or use of a promissory note (very low AFRs allow immunization at an extremely low cost). Use a short term note when immunizing a 2-year GRAT.

Planning to Obtain Step Up in Cost Basis

- **No Step Up in Basis**: The GRAT “profit” passing to the beneficiaries at the end of the GRAT term do not receive a “step up” in cost basis for capital gain purposes.
- **23.8% Rate**: Planning to avoid “carryover basis” is of greater importance at a 23.8% capital gain rate.

Planning to Obtain Step-Up in Cost Basis

Planning Options: There are two options for the grantor to consider:

- **Sell the assets before the GRAT term ends:**

1. The grantor will pay the capital gain tax on the sale.
2. The capital gain rate may be the same or higher than the GRAT beneficiary
3. The 3.8% surcharge is only applicable to certain high income taxpayers.
4. The grantor may have capital losses to offset the sale.
5. Payment of the capital gain tax is in effect a “tax free gift” to the beneficiaries not using any of the grantor’s estate and gift tax exemption.

- **Swap assets with the GRAT:**

1. The GRAT agreement should direct that the grantor may swap assets having equivalent value under IRC Section 675(4).
2. The grantor is not required to sell the assets received in the swap. The assets can be used to fund a new 2-year GRAT under a rolling GRAT plan or the grantor may simply retain the swapped assets and hold them.

Qualified Personal Residence Trusts (QPRTs)

- **Favorable Environment to Transfer Interest in Personal Residence Trust**
 - Increase in Gift Tax Exemption from \$5,490,000 to \$11,180,000 allows many clients to form a QPRT without paying gift tax.
 - Spousal Portability
 - Fractional Interest Discount Planning
- **Negative Factors in Using QPRT**
 - Low Sec. 7520 Interest Rate
 - Generation-Skipping Transfer (“GST”) Tax Planning Limitations
 - Mortality Risk
 - No “Step-Up” in Cost Basis
- **Alternate Approaches**
 - Direct Gift
 - Net Financed Gift
 - Joint “Split Interest” Purchase
 - Sale to Intentionally Defective Grantor Trust

QPRT Overview

- Creating and funding a QPRT is similar to a Grantor Retained Annuity Trust (“GRAT”)
 - Client transfers title to residence to Trust; retains right to reside
 - Designation of beneficiaries at end of QPRT Term
- The initial transfer of the residence to QPRT involves a taxable gift
 - Gifted amount is the actuarial value of the remainder interest passing to Client’s named beneficiary
 - Remained interest based on:
 - Value of residence
 - Age of grantor
 - Number of years retained
 - Interest rate at time of gift

QPRT Example

QPRT Example #1 Client (age 65) is contemplating the transfer a \$10,000,000 condominium to a QPRT with a term of 10, 15 or 20 years.

CLIENT QUALIFIED PERSONAL RESIDENCE TRUST

QPRT TERM	TAXABLE GIFT	GIFT TAX EXEMPTION	GIFT TAX
10 Years	\$ 5,957,200	\$ 5,450,000	\$166,880
15 Years	\$ 4,084,400	\$ 4,084,400	NONE
20 Years	\$ 2,413,200	\$ 2,413,200	NONE

Analysis of QPRT Example #1

- The amount of the gift decreases as the length of the retained term increases.
- If Client transfers her residence at a value of \$10,000,000 in trust and retains use of the residence for 15 years, then the amount of her gift is \$4,084,400.
- Assuming that Client survives the 15 year term and the residence increases in value at a 5% annual rate for 15 years, he would shelter property worth \$20,789,282 from estate tax by making a taxable gift of only \$4,084,400.
- Using a 40% estate tax rate, estate tax savings of \$6,681,953 would be obtained by funding the QPRT.
- In addition, all appreciation in the residence after the expiration of the 15 year term and before Client passes away would also avoid the 40% estate tax.
- However, there will be capital gain tax payable if the residence is sold by the remainder beneficiaries.

Use of Multiple QPRTs

- **Multiple Residences**
- **Multiple QPRTs Funded With a Single Residence**

Factors Impacting QPRT Planning

There are five primary factors involved in QPRT planning:

- Section 7520 Rate
- Life Expectancy
- Value of Real Estate
- Fractional Interest Discounts
- Cost Basis of Residence

QPRT Example #2 – 6.0% AFR (Instead of 3.0% AFR)

QPRT Example #2 Instead, Client gifted a \$10,000,000 condominium to a QPRT with a term of 10, 15 or 20 years when the AFR was 6.0% (as opposed to 3.0%).

CLIENT QPRT (3.0% VS. 6.0% AFR)

QPRT TERM	TAXABLE GIFT @ 3% AFR	TAXABLE GIFT @ 6% AFR
10 Years	\$ 5,957,200	\$ 4,384,400
15 Years	\$ 4,084,400	\$ 2,578,900
20 Years	\$ 2,413,200	\$ 1,307,200

Analysis of QPRT Example #2

- If Client transfers her residence at a value of \$10,000,000 in trust and retains use of the residence for 15 years when the AFR is 3.0%, then the amount of the gift is \$4,084,400.
- If Client transfers her residence at a value of \$10,000,000 in trust and retains use of the residence for 15 years when the AFR is 6.0%, then the amount of the gift is reduced to \$2,578,900, a 37% decrease from the 3.0% AFR gift.

QPRT Example #3 – 70 Year Old Client

QPRT Example #3 Suppose that we learn that Client was actually 70 years old (not 65) when she transferred a \$10,000,000 condominium to a QPRT with a term of 10, 15 or 20 years when the AFR is 3.0%:

CLIENT QPRT (AGE 65 VS. AGE 70)

QPRT TERM	TAXABLE GIFT IF AGE 65	TAXABLE GIFT IF AGE 70
10 Years	\$ 5,957,200	\$ 5,055,800
15 Years	\$ 4,084,400	\$ 2,958,200
20 Years	\$ 2,413,200	\$ 1,367,400

Analysis of QPRT Example #3

- If Client transfers her residence at a value of \$10,000,000 in trust and retains use of the residence for 15 years at age 70 instead of age 65, then the amount of the gift is \$5,055,800, almost 20% less than the \$5,957,200 gift at age 65.
- The life expectancy of a 70 year old is 17 years, only 4 years less than the life expectancy of a 65 year old.

Establishing the QPRT Term

- Survival of QPRT Term
- Staggered QPRT Terms
 - Hedges mortality risk; and
 - Generates fractional interest valuation discounts.

Fractional Interest Discounting With QPRTs

Prominent Real Estate Fractional Interest Discount Decisions:

- *Estate of Ludwick vs. Commissioner*, Tax Court Memorandum 2010-104
- *Estate of Mitchell vs. Commissioner*, Tax Court Memorandum 2011-94

Use of Residence at End of QPRT Term

- Residential Lease; Rental Payments
- IRC Section 2036
- *Estate of Riese vs. Commissioner*, Tax Court Memorandum 2011-60
- Preservation of Homestead Status (Florida)

Maintaining Florida Homestead Status

The grantor of the QPRT can secure the continued benefits of the homestead exemption for the residence when leasing from the remainder beneficiaries if the following procedures are followed:

- The County Property Appraiser can “pre-approve” the continuation of the exemption. (This “pre-approval” can usually be obtained by email.)
- The Property Appraiser will require an explanatory letter and the following documents:
 - Deed;
 - Lease
 - Memorandum of Lease (in recordable form); and
 - Copy of the QPRT.
- Following the termination of the QPRT, the Deed and the Memorandum of Lease must be recorded. Then copies of the recorded instrument should be sent to the Property Appraiser with a request for confirmation of continuing homestead eligibility.

QPRT Administration

- Sale of Residence
- Improvements to Residence
- Mortgage on Residence
- Rental of Residence

Sale of Residence During QPRT Term

- May Sell At Any Time/Purchase of Replacement Residence
- Cost Basis
- Section 121 Exclusion from Tax on Sale of Personal Residence
- QPRT Status After Sale of Residence

Conversion of QPRT to a GRAT Following Sale of Home

- QPRT Conversion
- GRAT Annuity Payments
- Multiple GRAT Conversions
- Required Conversion Date
- Required GRAT Payment Date

Use of Residence by Donor after QPRT Term

- Repurchase by Donor
 - Grantor Trust
 - Section 2036 Concerns
- Lease Back by Donor

Sale to Grantor Trust - In General

- **Definition**: A sale to a grantor trust is a strategy in which a grantor trust essentially borrows funds from the grantor which it invests in a manner that (hopefully) produces a rate of return that is greater than the interest rate on the note evidencing the debt.
- **Sale**: The grantor sells assets (e.g., stock, partnership interests) to the grantor trust in exchange for a promissory note issued by the trust.
 - As long as the promissory note bears interest at the appropriate AFR, the value of the note for gift tax purposes will be its face amount. No gift will occur upon the sale to the trust for a note.
 - As the sale is made to a grantor trust, as to the grantor, the loan evidenced by the note is treated as being between the grantor and herself for income tax purposes.
 - As a result, the grantor does not recognize interest income on account of the note.

Sale to Grantor Trust - In General (continued)

- **Grantor Trust:** The Service held in Revenue Ruling 85-13 (and in several PLRs) that transactions between a grantor trust and its grantor have no income tax consequences because the property of a grantor trust is treated as owned by the grantor for income tax purposes.
 - Thus, no gain is recognized upon the grantor's sale of assets to the grantor trust.
 - Moreover, the trust can satisfy its obligation on the note with appreciated property without income tax consequences.

Example 6: Sale to a Grantor Trust

John previously created a grantor trust that currently has \$1 million of assets. He sells \$9 million of securities to the trust for a 9-year promissory note paying the mid-term AFR, which is assumed to be 1%. The note is structured so that the interest is payable annually, with a balloon payment of the principal due at maturity. Because the trust is a grantor trust, it is ignored for income tax purposes, and John does not recognize gain on his sale of securities to the trust.

At this point, John owns a non-appreciating fixed income promissory note.

- The note pays him \$90,000 of interest ($\$9 \text{ million purchase price} \times 1\% = \$90,000$) each year for 9 years.
- Because the trust is a grantor trust, John is not subject to tax on his receipt of interest payments under the note.

Example 6: Sale to a Grantor Trust

If the trust realizes a 10% annual rate of return, at the end of 9 years the trust will have roughly \$11,900,000 (after repayment of the debt).

- Approximately \$2,600,000 of the trust value is attributable to the \$1,000,000 initially held in the trust.
- The benefit of the sale is \$9,300,000.

Sale to Grantor Trust - Benefits of Sale to Grantor Trust

- **No Gain Recognition**: Because the grantor is treated as the owner of trust property, his sale of assets to the trust in exchange for the promissory note will not be ignored for income tax purposes. As a result, the grantor will not recognize gain or loss upon the sale and will not be taxed on the interest paid by the trust in respect of the promissory note.
- **Tax-Free Transfers**: Assuming the face value of the note is equal to the FMV of the assets purchased and the note bears interest at the AFR, the sale to the trust will not constitute a taxable gift. All income earned by, and all appreciating on the value of, the property held by the grantor trust in excess of the interest and principal of the trust under the promissory note will accrue to the benefit of the trust beneficiaries free of gift and estate tax. In addition, like all grantor trusts, the grantor's payments of income tax in respect of income earned by the trust are, in effect, gift tax free transfers to the trust.

Sale to Grantor Trust

Benefits of Sale to Grantor Trust (continued)

- **Cash Flow**: The income received by the grantor trust in respect of its investments may be used to make interest and principal payments to the grantor under the promissory note. As a result, the grantor's cash flow is maintained while the note is outstanding, and he may use the interest payments to fund his income tax liability attributable to income and capital gains realized by the grantor trust.
- **Non-Appreciating Asset**: The promissory note will not appreciate in the grantor's estate and thus the growth of the grantor's estate is limited to the interest on the note.

Risks and Problems with Sales to Grantor Trusts

- **Debt-to-Equity Ratio**: If the debt-to-equity ratio of the grantor trust is too high, the Service could attempt to re-characterize the sale as a gift to the trust in which you retained an interest (e.g., the income from the property) on the theory that because the trust is undercapitalized (making the note a riskier investment), no seller would agree to sell his assets to the trust for a note in an arm's length transaction.
 - If successful, the retained interest would be given zero value under Code Section 2702 and the grantor would be treated as having made a gift of all of the property transferred (triggering gift tax).
 - Moreover, the property would still be included in his estate if he died before the note was paid off under Section 2036.
 - As a result, the trust should have at least 10% equity (9:1 maximum debt to equity ratio).
 - Otherwise, there is a greater risk the IRS would successfully challenge the substance of the sale and note.

Sale to Grantor Trust- Risks and Problems

- **Annual Cash Flow Requirements:** The trust has annual payments to fund, and a large balloon payment upon the note's maturity.
 - One must find assets that can generate sufficient cash flow to make these payments, or the trust will need to make payments in kind.
 - If the trust purchased stock in a closely held business, paying in kind will require expensive valuations and will be counterproductive to the client's goals.
- **Death Before Note Discharged:** Upon the grantor's death, the trust will cease to be a grantor trust.
 - When a trust ceases to be a grantor trust it is no longer disregarded for income tax purposes.
 - At such time, the trust essentially springs into life for income tax purposes.
- **Investment Performance Risk:** A sale has significant risk associated with poor investment performance.

Gift Tax Return – Adequate Disclosure of Sale

- **Purpose of Disclosure** – The purpose of adequately disclosing the sale on the federal gift tax return is to begin the running of the statute of limitations. After the statute of limitations has run, the Service is barred from examining the nature of the transfer and the basis for the value reported on the Form 709.
- **Disclosure Requirements** – The general requirements for adequate disclosure are listed in Treas. Reg. §301.6501(c)-1(f)(2).
 - **Qualified Appraiser** – The regulations require that a qualified appraiser be used. Treas. Reg. §1.1704-13(c)(5)(iv) outlines persons who *cannot* serve as qualified appraisers.
- **Adequate Disclosure of Interests in Corporations, Partnerships and Trusts** – In addition to the requirements of Treas. Reg. §301.6501(c)-1(f)(2), gifts involving an interest in a corporation, partnership or trust must also comply with the disclosure requirements stated in Treas. Reg. § 301.6501(c)-1(e)(2).

Adequate Disclosure Requirements

The requirements for adequate disclosure on Form 709 include:

1. A description of the transferred property and any consideration received by the transferor.
2. The identity of, and relationship between, the transferor and transferee(s).
3. The trust's tax identification number and either (a) a brief description of the terms of the governing trust, or (b) a copy of the trust instrument.
4. Either (a) a qualified appraisal, or (b) an extensive description of the asset transferred as outlined in Treas. Reg. §301.6501(c)-1(f)(2)(iv).
5. A statement describing any position taken that is contrary to proposed, temporary, or final Treasury Regulations or revenue rulings published at the time of the transfer.

Interest Rate

- **The mid-term (9-year) interest rate in August 2018 is 2.80%**
 - The GRAT 7520 rate is 120% of the mid-term AFR.
 - The GRAT hurdle rate is always higher than the mid-term note rate.
 - The GRAT hurdle rate is generally (but not always) higher than the short-term note rate.

Advantages of a GRAT

- Can use 2-year GRAT term to capture asset volatility.
- Easier for client to understand
- Statutory technique.
- Less complicated (and less expensive) than a sale to a grantor trust.
- Can fund without using any gift tax exemption.
- No uncertainty with income tax treatment of note if grantor dies during sale term.

Advantages of Sale to a Grantor Trust

- Lower interest rate:
 - 9-year note in August 2018 is 2.80%
 - August 2018 7520 rate is 3.4%
- Can transfer appreciation to an exempt generation-skipping trust.
- No mortality risk.
- Can fund with illiquid assets and pay interest only for term of a balloon note.
- Grantor trust status may be terminated at later date.
- Promissory note can be refinanced if interest rates decline.
- Can use the same grantor in later transactions