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A String of Bad Luck: GRAT Assets Included in Taxable Estate

9th Circuit finds that the decedent retained enjoyment of a grantor retained annuity trust.

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In *Badgley v. United States*, the 9th U.S. Circuit Court of Appeals addressed the includability of a grantor retained annuity trust (GRAT) in the taxable estate of a decedent who died during the annuity period. Finding that the decedent's retained annuity constituted enjoyment of the property within the meaning of Internal

Revenue Code Section 2036, the court affirmed the district court's summary judgment in favor of the Internal Revenue Service.

Decedent Died Before GRAT Ended

In February 1998, Patricia Yoder created a GRAT, retaining the right to an annual annuity for a 15-year term. On the earlier of the term's expiration and her death, the remainder interest transferred to Patricia's daughters under the terms of the GRAT. Patricia funded the GRAT with a partnership interest valued at approximately $2.4 million and filed a gift tax return reporting the gift of the GRAT's remainder interest. Patricia died on Nov. 2, 2012, shortly before the end of the GRAT term.

An estate tax return was filed, in which the entire date-of-death value of the GRAT was included in the gross estate. The executor of Patricia's estate subsequently filed an action for a tax refund, asserting that only the present value of the unpaid annuity payments should have been included. The district court rejected the executor's argument, holding that Patricia's annuity interest constituted both a retained right to income and continued enjoyment of the property within the meaning of IRC Section 2036 and was therefore wholly includible.

Strings Attached

The executor argued that the GRAT wasn't includible in the Patricia's gross estate, as Section 2036 fails to explicitly address annuities. The court soundly rejects this "form over substance" approach in an eloquent decision describing Section 2036 as "stand[ing] for the proposition that if the taxpayer does not let the property go, neither will the taxman."

The court describes Section 2036 as requiring inclusion of purportedly transferred property over which the taxpayer retains possession, enjoyment or a right to income for her lifetime. When a taxpayer retains a sufficient connection to the transferred property through possession, enjoyment or a right to income (a "string" binding the taxpayer to the property) for her lifetime, and the transfer takes effect only on the taxpayer's death (a "will substitute"), property will be included in her taxable estate. The court depicts Section 2036 as a two-faceted inquiry, based both on the retained connection of the grantor to the property and on the timing of the beneficiaries' interest taking effect.

Here, Patricia retained a "substantial present economic benefit" from the GRAT, in the form of the 15-year annuity, and the GRAT property was transferred to her daughters on her death. Because "the grantor retain[ed] enjoyment" of the GRAT, the court held the GRAT was properly includible in her taxable estate.

Takeaways

The case is unremarkable from a legal perspective. The decision itself acknowledges that "[i]nclusion … should come as no surprise to GRAT grantors." GRATs offer the possibility of transferring appreciation from one's taxable estate with minimal or no gift tax by reducing or zeroing out the value of the remainder interest (through tinkering with the trust term and annuity amount). Simultaneously, T&E practitioners are well aware of the primary risk posed by a GRAT; namely, the mortality of a grantor during the GRAT's term. A GRAT's success is predicated on avoiding estate tax, in addition to gift tax, and GRAT property will be excluded only from the estate of a grantor who survives the GRAT term. Survive the term—and the taxpayer wins, having transferred appreciation (in excess of the annuity) free from gift tax and having removed the GRAT property from her taxable estate (and as an added bonus, living to tell the tale). Die during the term—and the government coffers win, with the inclusion of the GRAT property in the taxpayer's gross estate.

The fact pattern is similarly unexceptional. Grantor sets up a GRAT and dies before its expiration. The court notes that Patricia explained to her daughters (one of whom was the executor) that the partnership interest "would probably go back into her estate" for tax purposes were she to pass away during the GRAT term. The author of the decision pulls no heart strings for the executor.

However, while the holding was unremarkable, the dicta of the decision included several interesting nuggets.

1. Legal writing tends to be dry, fact-driven and intimidating. In contrast, the author of the decision uses language alternating between lyrical prose, witticisms and common English. ("Thanks to Benjamin Franklin, death and taxes are inextricably linked in most Americans' minds as the only two things in this world that are certain. Thanks to the estate tax, certainty is not the only tie.") The decision is worth perusing for the language, if nothing else.
2. The decision is an excellent primer on GRAT basics, for those looking to educate their associates (or themselves).
3. In a more careful reading of the decision, and of possible academic interest, the court concluded that Patricia retained "enjoyment of the property for purposes of Section 2036(a)" while the district court concluded that the annuity constituted both enjoyment and the right to income. The executor (and her counsel) argued extensively that the annuity didn't constitute "income" within the meaning of Section 2036 and focused on the source of the funds used to pay the annuity in question. The court seems to agree. However, the executor's Pyrrhic victory, if any, is largely irrelevant as her arguments were soundly defeated on the basis of "enjoyment" and "substitute for wills."