We Know it When We see it: How to Draft GRATs to Zero Them Out For Gift Tax Purposes

1. DRAFTING GRATS IN LIGHT OF THE NEW, 2004, GRAT TREASURY REGULATION

From prior articles, we know that the Grantor Retained Annuity Trust (or "GRAT") is one of the leading estate tax strategies available to the estate planning attorney (see ____edition of Journal of Passthrough Entities). And we know that the goal of GRATs is to zero out the valuation for gift tax purposes.

Zeroing out means that the value of the retained interest held by the grantor must equal or exceed the value of the property placed into the GRAT. The valuation of the retained interest is a straightforward discounted present value of an annuity for a term of years (algebraic formula that can be done with a simple calculator, nothing fancy).

But it must be a term of years, not dependent on the grantor's life. The term of years should pay out in the GRAT regardless of whether the Grantor is living or has died during that time. If the Grantor dies during that time, the remaining annuity interest should be paid to his or her estate. In this way, the value of the annuity will not be based on any life expectancy issues.

Importantly, the Treasury just passed new regulations recognizing that GRATs could be zeroed out for gift tax purposes. Understanding the effect of this regulation on the drafting of GRATs, and drafting in accord with this regulation, is the topic of this month's column.

This is a tremendous impetus to the use of GRATs, because now highly volatile investments, capable of substantial returns in excess of the 7520 rate, can be put in the GRAT without concern, from a transfer tax standpoint, of these assets severely dropping in value. But they must be drafted correctly. Zeroed out GRATs can be created but, like other aspects of estate planning, do require sensitivity in drafting.

In this regard, the Regulation impacts both (1) how to draft to zero out a GRAT for gift tax purposes, and (2) if doing so, how to make sure the remaining annuity payments and amounts to the deceased grantor's estate (because the grantor died before the retained interest term) qualifies for the marital deduction.

This column looks at what additional drafting is now required because of the Treasury Regulation

2. SOUNDS STRAIGHTFORWARD ENOUGH? THE REGULATION

The new regulation provides, in part:

"§ 25.2702-2 Definitions and valuation rules.

> (a) * * *
>
> (5) Holder. The holder is the person to whom the annuity or unitrust interest is payable during the fixed term of that interest. **References to holder shall also include the estate of that person**." 26 CFR Part 25 [TD 9181]RIN 1545-BB72 (emphasis added).

Drafting for the zeroed out GRAT becomes an issue needing focus. It is not merely that if the grantor dies before the end of the retained term, the remaining GRAT is paid to the grantor's living trust or Will. Under the discussion to the new regulations this is not permissible.

Rather, the remaining GRAT annuity payments must be paid to the grantor's estate. In other words, a GRAT is always zeroed out so that if the annuity payments are made during the retained term, that the discounted present value of those annuity payments are zero. Therefore, if the grantor dies before the end of the retained term, the remaining term must receive the designated annuity payments. And the "estate" takes over as the grantor.

<u>Example 1:</u> The grantor sets up a 5 year GRAT, meaning that she gets an annuity during this 5 year period. Each year, she must get about 23 % of the initial fair market value of the GRAT in order for her interest to equal 0; that is, receiving 23 % per year for 5 years, under an assumed interest rate environment of 4.8% results in the grantor retaining 100 % of the initial value transferred to the GRAT. No taxable gift is made for gift tax purposes. If the grantor dies in year 4, after receiving the first 3 payments, where must the remaining 2 payments be made to? The GRAT must prescribe that those payments be made to the "grantor" who, when she is dead, becomes her estate.   Under the regulations, "References to holder shall also include the estate of that person."

Does the term, "estate," mean "living trust?" It should conceptually; but it doesn't say that.

Accordingly, a more careful drafting approach is to provide that remaining annuity payments go to the grantor's estate or, if it qualifies as an "estate" under the regulations, then to the grantor's living trust.

<u>*Drafting Example 1*</u>: "**Annuity Payments**. On each anniversary of the date of the creation of the trust, the trustee shall pay to me or, if I am not then living, to the personal representative of my estate, the "annuity amount," as subsequently defined in this paragraph. The "annuity amount" shall equal an amount equal to <u>X%</u> of the initial fair market value of the property transferred to the trust on the date of execution of this agreement, as finally determined for federal tax purposes; provided, however, that if the annuity amount is paid to the personal representative of my estate, it shall also include the excess of the net income of the trust over the said percentage amount of the initial fair market value. Notwithstanding any other provision, no payment shall be made during my life from the Annuity Trust to any person other than me, and no payment shall be made from the Annuity Trust to any person or entity other than the personal representative of my estate if I shall die before the termination of the Annuity Trust."

The problem with the above approach is that for grantors in states in which probate is to be avoided as a four letter word, the remaining annuity payments are very desirous to go to a living trust, not a probate estate. In that case, hedging one’s bets means a bit more creativity in drafting, like the following.

<u>*Drafting Example 2*</u>: "**Annuity Payments**. On each anniversary of the date of the creation of the trust, the trustee shall pay to me or, if I am not then living, to the then acting trustee of the Bill Jones Trust, dated February 16, 2001, as amended and restated from time to time and as in effect at my death (my "Living Trust"), or if my Living Trust shall not be in effect at my death (or shall not be my estate for purposes of the treasury regulations), then to the personal representative of my estate , an amount equal to X% of the initial fair market value of the property transferred to the trust (“the annuity amount”) determined as of the date of the receipt of property. No payment shall be made during my life from the Annuity Trust to any person other than me, and no payment shall be made from the Annuity Trust to any person or entity other than my Living Trust or the personal representative of my estate (or the successor in interest thereto) if I shall die before the termination of the Annuity Trust."

3. PART TWO: DON’T UNMARITAL THAT DEDUCTION

When a GRAT is established and there could be a surviving spouse, then in most cases the GRAT should be structured to qualify for the marital deduction if the first spouse passes away before the retained term expires. In that case, though the GRAT would be included in the gross estate, it would qualify for the marital deduction and defer taxes (or not use any part of the applicable exclusion amount, currently $1,500,000). There are two ways to achieve this. One is to draft a marital trust within the GRAT itself, as a sort of self contained subtrust of the GRAT. The alternative is to draft so that the GRAT property   that comes back into the first spouse’s gross estate to qualify for the marital deduction.

To accomplish this, it is important to consider a couple of boundaries. First, to make sure that the GRAT qualifies for the “zeroing out” treatment, the GRAT will provide that the remaining annuity payments continue to be paid to the decedent’s estate. And at the end of the retained term, the remaining GRAT property could be paid to the decedent’s estate. This should be enough to qualify for the marital deduction, like any other property that would be payable directly to a decedent’s estate.

However, <u>to be overly protective</u>, a provision can be included in the GRAT to make sure that in addition to the annuity payments made to the grantor’s estate during the remaining retained interest period, if there is excess “income” (over and above these annuity payments, which would be unlikely), that this excess income is also paid annually to the grantor’s estate. In addition, in the grantor’s Will or living trust document, a provision could be added to make sure that all income from this property is paid to the spouse during the period of administration.

<u>*Drafting Example 3*</u>: [In Grantor's Living Trust] "**Income Attributable to GRAT**. Anything contained in this instrument to the contrary notwithstanding, the marital trust shall be entitled to receive or be allocated, either directly or indirectly, any property from a so-called “Grantor Retained Annuity Trust” (“GRAT”). In order to cause the value of such property to qualify for a marital deduction in determining my taxable estate under the marital deduction provisions of the federal estate tax law applicable to my estate, the

income from the GRAT property therein to be received, but not yet received during any taxable year, by the marital trust must be paid to my spouse not less often than annually, and the Trustees of the marital trust shall distribute to my spouse at least annually, in addition to any other amounts required to be distributed to my spouse , all of such income or an amount equal to all of such income, to the end that the value of such property will in fact qualify for such marital deduction, and the provisions of this paragraph shall be construed and interpreted broadly to carry out my said intention."

As noted above, in addition to the remaining annuity payments passing to the grantor's estate, the GRAT should provide that any property that remains after the retained term expires passes to the spouse, outright, or to the marital trust under the decedent's document.

Drafting Example 4: "**Distribution on Termination If I Am Not Then** If I am not living on the Annuity Trust Termination Date, then the trustee, after paying the Final Annuity Amounts (assuming they have not been paid prior to the Annuity Trust Termination Date), shall distribute the remaining income, if any, and principal, if any, of the Annuity Trust to the then acting trustee under that certain Declaration of Trust known as the "JOHN SMITH 2005 TRUST," created by me as Settlor on January 1, 2005, as previously amended by me and as may be further amended by me at any time and from time to time prior to my death ("my Declaration of Trust"), to be added to and become a part of the "Trust Estate" thereunder, and to be held, administered and distributed as a part thereof, as provided in my Declaration of Trust as in force at my death, or if my Declaration of Trust is not in force at my death, then to the personal representative of my estate."