A Volatile Estate Tax Reduction Concoction: The Use of Partnerships, Marketable Assets, and GRATs (ParmaGRATs)

Putting the Pieces Together

In past articles we have discussed the continued viability of Grantor Retained Annuity Trust ("GRAT") and partnership planning in today's estate tax reduction environment. [Insert cites from prior JPTEs.] There is noise that the GRAT as we know it could be legislated away, and yet there are no pending bills to achieve that. The Treasury can try to issue pronouncements about remainder interests in GRATs but this smells like *Walton* revisited.

For now, with the *Mirowski* opinion, T.C. Memo. 2008-74, discussed in **_____**, and section 2702 still in effect, the creative use of GRATs, limited partnership interests, and marketable assets can combine to form an effective estate tax reduction strategy. This is especially key in the current economic times, where the decline of stocks, which may continue, are reaching levels not seen for a decade. If the tide turns, and the market goes up, now is an especially good time to transfer that appreciation to the client's children with a GRAT.

The Endemic Problem

Assume that a family has established a limited partnership for non tax and tax reasons, but that the non tax reasons are persuasive and valid. In other words, the partnership will be respected for discount purposes under current law.

With a GRAT funded with limited partnership interests only, the annuity amounts are typically going to be satisfied with limited partnership interests transferred out of the GRAT to the grantor. If the partnership tries to make distributions from the partnership, this invokes substantial 2036 issues to the grantor down the road, as well as typically going counter to the likely business reason justifying (for tax purposes) the creation of the partnership. If partnership interests are discounted going into the partnership, and then distributed, then they will be discounted coming out. Less value is retained in the GRAT to pass to the beneficiaries. Less effective is the GRAT.

For example, assume that a year after establishment, the creator of the partnership transfers $800,000 of limited partnership interests to a GRAT, retaining an annuity right for 10 years. Assume the partnership interests are valued at a 20 % discount, and otherwise would be worth on liquidation $1,000,000. To zero out the GRAT, the retained annuity amount must be 12.45 % of the initial $ 800,000 transferred to the GRAT. See Table 2 below. Even if the partnership assets increase by 6% per year, almost all of the partnership, 90 % approximately, must be distributed back to the grantor in satisfaction of the annuity right.

Enter Marketable Assets

Accordingly, the goal is to create the GRAT, funded with limited partnership interests, but to add additional assets to the GRAT sufficient to allow the annuity obligation to be made without requiring limited partnership interest's to satisfy those payments.

Continue the example in which the goal is to transfer a $1,000,000 limited partnership interest, discounted by 20 % to $800,000, to the children over a period of 10 years without gift tax consequences. If the limited partnership is contributed to a 10 year GRAT, then even at a 6 % appreciation amount, the majority of the limited partnership interests will be returned to the grantor over the 10 year period per the schematic below. It will be, for the grantor's purposes, an ineffective GRAT.

The grantor must distribute 12.45% of the initial GRAT value each year (see chart 2 below), and even growing at 6 %, this will result in approximately only 10 % of the limited partnership interest being returned to the grantor in the form of the annuity. In that result, 90 % of the discounted partnership interest in not transferred to the children, as illustrated by the chart below.

Table 1: Partnership Assets Solely to Fund GRAT

Year	Partnership Assets	Increase by 6 %	Payment of annuity	Amount of Partnership Assets Remaining
1	$800,000	$848,000	$99,618	$748,382
2	748,382	793,285	$99,618	693,668
3	693,668	735,288	$99,618	635,670
4	635,670	673,810	$99,618	574,192
5	574,192	608,644	$99,618	509,026
6	509,026	539,568	$99,618	439,950
7	439,950	466,347	$99,618	366,729
8	366,729	388,733	$99,618	289,115
9	289,115	306,462	$99,618	206,845
10	206,845	219,255	$99,618	119,637

:

Add one wrinkle. The grantor has an investment portfolio of $10,000,000 made up of marketable assets and bonds, expected to earn an average combined return before taxes of 6 %. The retained annuity to zero out the GRAT at a section 7520 rate of 4.2 % is 12.45 %.

Table 2: Calculation of Zeroed Out GRAT Funded with Both Marketable Assets and LP Interests

Minimum Annuity Percentage for "Zero" Taxable Gift	
Date of Transfer to GRAT	November, 2008
Value of Liquid Assets transferred	$10,000,000
Value of Limited Partnership Interest discounted	$800,000
Total Initial Principal	$10,800,000
Section 7520 Rate (July 2005)	4.2%
Term of Years Retained	10
Annuity Percentage	12.45221%
Annuity Payment	**$1,344,839**

If each year, in kind assets (either of income or principal) are returned to the grantor in satisfaction of the annuity rights, then at the end of the 10 year period, the limited partnership interest will remain in the GRAT and belong to the children; thereby having been effectively transferred under the GRAT Code section 2702. As illustrated by the table below, the annuity obligation is satisfied in full by the in kind distribution of marketable assets over the 10 year period.

Year	Marketable Assets	Increase by 6 %	Payment of annuity	Amount of Marketable Assets Remaining
1	$10,000,000	$10,600,000	$1,344,839	$9,255,161
2	9,255,161	9,810,470	1,344,839	8,465,631
3	8,465,631	8,973,569	1,344,839	7,628,730
4	7,628,730	8,086,454	1,344,839	6,741,615
5	6,741,615	7,146,111	1,344,839	5,801,272
6	5,801,272	6,149,349	1,344,839	4,804,509
7	4,804,509	5,092,780	1,344,839	3,747,941
8	3,747,941	3,972,817	1,344,839	2,627,978
9	2,627,978	2,785,657	1,344,839	1,440,818
10	1,440,818	1,527,267	1,344,839	182,428

The distribution of in kind assets to satisfy an annuity obligation triggers income tax considerations. Typically, this kind of distribution could be a capital event, in that a debt type obligation (the obligation to pay the annuity) is being satisfied with an asset that may have capital gain (the in kind distribution). But not in the GRAT scenario. Because the GRAT is a grantor trust, the distribution of the in kind asset is a distribution from a grantor trust to the grantor, and is therefore ignored for income tax purposes.

Iterations

Iterations to the above illustration are effective. The theme is that illiquid assets like partnership interests (or other interests in closely held businesses) that generate minimal cash flow can be contributed to a GRAT and have that GRAT effective to eventually transfer the illiquid asset, provided the GRAT also has an ample supply of marketable assets or other liquid assets that will have sufficient appreciation. The key to the success of these strategies lies in the modeling, resulting appreciation, and creative structure of the GRAT using pass through entities and marketable assets.