2

Calculating the Potential for Transfer Tax Savings in Personal Residence GRITs

The possibility of appreciation, the value of a reversionary interest, and the opportunity cost of alternative gifts all must be considered.

BY LOUIS S. HARRISON

To the concern of tax practitioners, there recently appeared in the *Wall Street Journal* an article entitled "Estate Planners Can Save Taxes, Gain Flexibility with Trusts,"[1] discussing the advantages of a personal residence trust. Although the IRS often reacts to the appearance of a tax strategy in that newspaper as if it were a loophole to be plugged, the personal residence retained interest trust (frequently referred to as "a personal residence GRIT"[2]) is not an abusive technique for achieving transfer tax[3] savings.

Grantor Retained Interest Trusts

The retained interest trust funded with a personal residence is a type of grantor retained interest trust (GRINT). In a GRINT, a grantor establishes an irrevocable trust and retains one or more property rights from the trust for a term of years, or for a period ending on the first to occur of the grantor's death or the expiration of the term of years. The retained property right may be any of the following:

1. A use or income interest (a grantor retained income trust, or GRIT).
2. An annual fixed dollar amount, analogous to an annuity interest (a grantor retained annuity trust, or GRAT).
3. A percentage of the periodic FMV of the trust (a grantor retained unitrust, or GRUT).

At the expiration of the term of the retained property right, the funds are distributed outright or remain in trust for the remainder beneficiaries designated by the grantor at the establishment of the trust. If the grantor dies prior to the expiration of the grantor's retained interest term, the funds either pass to the remainder beneficiaries or, depending on the specific terms of the trust, may revert to the grantor's estate or be subject to a general power of appointment held by the grantor.

Because a GRINT is irrevocable and the grantor retains no right to alter the terms of the trust, the transfer of funds to the trust is a completed gift of the value of the property transferred less the value of the grantor's retained interests.[4] The retained interests include, as noted above, the right to receive the income, or an annuity-type payment, for a specified number of years or for a period ending on the first to occur of the grantor's death or the expiration of the term of years. The grantor also may retain a reversion in or general power of appointment over the property if death occurs before the expiration of the specified term. The greater the value for gift tax purposes of these retained interests, the lower the value of the taxable gift.

If the grantor survives the term of the retained interests, the remaining property in the trust passes to the beneficiaries, free of additional gift or estate tax. The only estate or gift tax cost associated with the transfer is the gift tax imposed when the trust was established.[5] If the grantor dies prior to the expiration of the retained interests, the value of the trust at that time is included in the grantor's gross estate if the retained property interest was an income or use interest.[6]

Residence GRITs

In 1990, Section 2702 was enacted to correct valuation abuses associated with GRINTs.[7] That section applies in determining the gift tax value of a transfer of certain interests in trust to or for the benefit of a member of the transferor's family when the transferor retains an interest in the trust.[8] The statute does not apply to an incomplete transfer, and hence has no application to a revocable trust.[9]

The gift tax value of the transfer of an interest in trust to a member of the family is the full value of the property transferred less the value, determined pursuant to specific rules in Section 2702(a)(2) and (b), of the property rights retained by the grantor. A retention of a right determined by reference to the income (a GRIT) or a contingent reversionary right to trust corpus is valued at zero for gift tax purposes. The only interests taken into account are "qualified interests," which consist

LOUIS S. HARRISON is a partner in the Chicago law firm of Lord, Bissell & Brook and an adjunct professor of law at the DePaul University College of Law. He has written frequently on estate planning topics.

of (1) a fixed amount payable at least annually (a GRAT), (2) an amount payable at least annually that is a fixed percentage of the FMV of the trust's assets (a GRUT), or (3) a noncontingent remainder interest if all of the other interests in the trust consist of interests described in (1) or (2). Because the retained interest must be structured as a "qualified interest," an outright gift, instead of a gift via a retained interest trust, will achieve greater transfer tax savings in certain situations. For example, in order for a GRAT to save more in transfer taxes than an outright gift, the GRAT must increase in value at a rate greater than the gift tax discount rate used in valuing the remainder interest.[10]

Under a narrow exception, the valuation rules in Section 2702 do not apply to certain transfers of interests in a personal residence.[11] Accordingly, pre-Section 2702 law could be used to value a GRINT funded with a personal residence. The grantor could retain both the right to use the trust property for a fixed term and the right to receive the trust property (or direct where the trust property goes) if the grantor died during that term. These retained interests would be valued pursuant to Reg. 25.2512-5 and Section 7520.

For purposes of this exception, a personal residence must be either a principal residence of the term holder, as defined in Section 1034, any other residence of the term holder, as intended by Section 280A(d)(1) (but without regard to Section 280A(d)(2)), or an undivided fractional interest in either of the above.[12]

The greater the value for gift tax purposes of the retained interests, the lower the value of the taxable gift.

The trust is permitted to hold cash, but not in excess of the amount required for expenses already incurred or reasonably expected to be incurred within any six-month period, for improvements to the residence to be paid for in six months and, generally, for the purchase of a personal residence within three months.[13] A personal residence subject to a mortgage can be contributed to a GRIT.[14]

An individual may not be the holder of a term interest in more than two personal residence trusts. A personal residence trust may not include household furnishings or other personal property.[15] A personal residence must be used exclusively as the term holder's residence "when occupied by the term holder."[16] Further, a personal residence may include appurtenant structures used for residential purposes and adjacent land "not in excess of that which is reasonably appropriate for residential purposes."[17]

The trust instrument. The drafting of a personal residence GRIT must be done with care. Provisions that must be included in the governing instrument depend on whether the trust (1) is intended to hold only a personal residence with no possibility of a sale during the retained interest

[1] 10/26/93, at page C1.

[2] Reg. 25.2702-5(b). If the trust holds both a personal residence and cash, or the document allows for the sale of the personal residence during the retained interest term or conversion of the trust to a grantor retained annuity trust (GRAT), the arrangement is formally referred to as a "qualified personal residence trust" (QPRT). Reg. 25.2702-5(c).

[3] As used in this article, "transfer taxes" refers to only estate and gift taxes, not generation-skipping tax. The principles discussed herein are applied using diverse gift tax discount rates (Section 7520) and various assumed rates of return.

[4] Reg. 25.2511-2. For gift tax purposes, a gift is technically incomplete as to the value of that portion retained by the grantor. See also Regs. 25.2511-1(e) and (h)(7).

[5] The gift is of the remainder interest, which is a future interest that does not qualify for the annual exclusion. Section 2503(b).

[6] Section 2036(a)(1). Inclusion in the gross estate also may be mandated by Section 2037(a), which applies to property transferred for less than full and adequate consideration if the decedent retained a reversionary interest in the property exceeding 5% of the value of the property immediately before the decedent's death. The three-year rule of Section 2035 does not apply when the grantor's income or reversionary interest expires, because there is no "transfer" at that time—the termination is merely a lapse.

[7] For a discussion of those abuses, see generally Lee, "The Economics of a GRIT," 68 Taxes 555 (July 1990). See also Blattmachr and Painter, "Planning for Split-Interest Transfers Under the Section 2702 Final Regulations," 77 JTAX 18 (July 1992).

[8] Members of the family include the transferor's spouse, lineal descendants and ancestors, brothers and sisters, lineal descendants and ancestors of the transferor's spouse, and spouses of any of the foregoing. Sections 2702(e), 2704(c)(2); Reg. 25.2702-2(a)(1).

[9] Section 2702(a)(3)(A)(i). An incomplete transfer refers to a transfer no part of which would be a gift even if no consideration was received by the transferor. Reg. 25.2702-1(c)(1). The rules also do not apply to charitable remainder trusts or pooled income funds. Regs. 25.2702-1(c)(3) and (4).

[10] See generally Blattmachr, "When Should Planners Consider Using Split-Interest Transfers?," 21 Est. Plan. 20 (Jan/Feb 1994).

[11] Section 2702(a)(3)(A)(ii); Reg. 25.2702-5(a).

[12] Regs. 25.2702-5(b)(2), (c)(2). See also Ltr. Rul. 9151046 (ownership of the residence through stock in a cooperative housing corporation does not preclude qualification as a personal residence).

[13] Reg. 25.2702-5(c)(5)(ii)(A). If additions of cash are made to purchase the initial or a replacement residence, the trustee must have entered into a contract to purchase the residence prior to the addition. *Id.* An addition of cash would be a separate taxable gift.

[14] Reg. 25.2702-5(c)(2)(ii). See Ltr. Rul. 9340009. A personal residence encumbered prior to transfer does not maximize transfer tax gain, however. The objective is to transfer as much net value as possible to the GRIT. Accordingly, debts and liens associated with the property should be paid prior to transfer. If mortgage payments are made on behalf of the trust, the part of the payment that reduces principal logically should be treated as an additional gift to the trust. See Covey, "Recent Developments Concerning Estate, Gift and Income Taxation—1991," 26 *U. Miami Inst. on Est. Plan.* ¶129.4(F) (1992).

[15] Reg. 25.2702-5(c)(2)(ii).

[16] Regs. 25.2702-5(b)(2)(iii), (c)(2)(iii). The residence may be rented, however, provided the requirements of Section 280A(d)(1) are satisfied. *Id.* See also Reg. 25.2702-5(d), Example 2. The Regulations allow a portion of the residence to be used for Section 280A(c)(1) or (4) activities if such use is secondary to use as a residence. Use of a residence as a "bed and breakfast" is prohibited. *Id.*

[17] Reg. 25.2702-5(b)(2)(ii). Recent letter rulings have clarified this requirement. For example, in Ltr. Rul. 9328040, the Service ruled that a vacation home that had on its property a "small ranch style structure" was permissible, primarily because no rent or other consideration was to be paid by the users of the property. See also Ltr. Ruls. 9249014 (two penthouse apartments and the hall space between them constituted one qualified residence) and 9343034 (distinct parcels of land can constitute "adjacent land").

term, or (2) will be permitted to sell the residence or otherwise hold cash.[18] For example, the governing instrument should either prohibit sale during the retained use term[19] or provide, if the personal residence is sold, for one of the following:

1. The proceeds be held in a separate account and used within two years (or prior to the expiration of the retained interest term, if earlier) to purchase another residence to be used by the term holder as a personal residence.
2. The proceeds not used to purchase another residence within two years (or prior to the expiration of the retained interest term) be distributed to the term holder.
3. The retained interest be converted to an annuity interest (if the retained interest term has not expired).[20]

Analogously, the trust should either prohibit use for a purpose other than as a personal residence of the term holder (during the retained interest term) or, if such use is permitted, should provide that within 30 days after the personal residence is not used or held for use as such by the term holder,[21] the assets be distributed outright to the term holder or be converted to a retained annuity interest.[22]

Further, if the trust is intended to hold cash as permitted by the Regulations, the instrument must prohibit distributions of corpus to any beneficiary other than the term holder during the term interest, must require that income be distributed to the term holder at least annually, and should prohibit commutation of the term holder's interest.[23] It must require that the cash held by the trust in excess of permissible amounts be distributed at least quarterly to the term holder and, on the termination of the term holder's interest in the trust, any cash held for the payment of expenses be distributed outright to the term holder.[24] The instrument must provide that the trust estate consist solely of only one personal residence used or held for use by the grantor (except for cash and sale or insurance proceeds, if the provisions discussed above are included).[25]

Transfer Tax Savings

The personal residence GRIT can achieve transfer tax savings in two ways. Because the Section 2702 valuation rules do not apply, the grantor's retained use and reversionary (or power of appointment) interests will both be valued for gift tax purposes, thereby reducing the gift of the remainder interest in the GRIT.

Valuation of the retained use interest. Prior to Chapter 14, the initial gift of the remainder interest in a GRIT was calculated under both an assumed income payout rate and an assumed discount rate (both rates were the same) to determine the present value of the remainder interest for gift tax purposes.[26] The rate was 120% of the federal midterm rate in effect for the month of the transfer.[27] Thus, if the applicable Section 7520 discount rate was 8.2%, the valuation assumption was that the grantor received an income payout of 8.2% in an investment environment where the average yield was 8.2%. This concept also assumed that the FMV of the interest at the end of the term would equal the FMV of the interest at the beginning of the term.[28] Accordingly, the principal amount of the equity transferred to the GRIT was assumed to remain stable during the retained interest term.

For example, if the Section 7520 discount rate was 10.80%,[29] the grantor was assumed to be receiving a 10.80% rate of return each year as a result of the retained income interest. If the GRIT yielded 6.80% in income and 4% appreciation each year, the 6.80% in income was returned to the grantor while the 4% in growth was transferred to the remainder beneficiaries. This gain was free of gift tax to the remainder beneficiaries, since the initial gift tax valuation assumed that the grantor would be receiving income equal to 10.80% of the GRIT each year.[30]

[18] Generally, the Regulations distinguish between governing instrument requirements for a basic personal residence trust (Reg. 25.2702-5(b)) and a more sophisticated one designed to hold cash or allow for the sale of the personal residence or conversion to a qualified annuity interest during the retained interest term (Reg. 25.2702-5(c)).

[19] See Reg. 25.2702-5(b).

[20] Regs. 25.2702-5(c)(7) and (8). See also Ltr. Rul. 9151046. Similar provisions need to be included to permit the trust to hold insurance proceeds received as a result of damage to or destruction of the residence. Reg. 25.2702-5(c)(7)(B). If conversion to a qualified annuity interest is permitted, the trust must also (1) contain all the provisions relating to a GRAT required by Reg. 25.2702-3, (2) provide that the right to receive the annuity amount begins on the date of sale (or damage or destruction rendering the residence incapable of use), or when the residence ceases to be used or held for use as a personal residence, and (3) require that the annuity amount be at least the amount determined by the formula in the Regulations. Reg. 25.2702-5(c)(8).

[21] See Reg. 25.2702-5(d), Example 5, for an explanation of the phrase "held for use" and an example in the context of the grantor having to move into a nursing home during the retained interest term.

[22] Regs. 25.2702-5(c)(7) and (8).

[23] Regs. 25.2702-5(c)(3), (4), and (6). For a generic personal residence trust structured under Reg. 25.2702-5(b), which is not permitted to hold cash, the Regulations are silent on commutation. The statute's objectives, however, would indicate that commutation is unavailable.

[24] Reg. 25.2702-5(c)(5)(ii)(A)(2). Accrued expenses can be paid out of cash.

[25] Regs. 25.2702-5(b)(1), (c)(5)(i).

[26] Reg. 25.2512-5.

[27] Section 7520.

[28] The valuation procedures assume that any increase in value of the interest will equal the discount rate, and that this increased value will be distributed as income to the retained interest holder.

[29] The rate for January 1994 was 6.4%.

[30] As a result of this perceived abuse, particularly with respect to closely held stock annually yielding less than 2%, the Service imposed a "reasonable rate of return" requirement on GRITs. If the remainder interest was initially valued assuming an income interest at X%, and the grantor did not receive a "reasonable rate of income" (which was not defined but probably approximated X%), then in each year in which the grantor did not receive a reasonable rate of return the Service deemed the grantor to have made a taxable gift. See Ltr. Rul. 8806082. See also Ltr. Ruls. 8801008 (in a trust funded with S corporation stock with a dividend rate substantially lower than the average rate for publicly traded corporations, the grantor made a gift each year equal to the lost income that would have been recognized had the trust property been more productive); 8642028 (the valuation tables may not be used where property that produced a low rate of return, averaging less than 1% for the immediately preceding five years, was transferred to the GRIT and the grantor had no right to compel the trustee to make the property more productive); 8905045 (failure of the grantor each year to exercise power to make the trust "normally productive under the standards usually applicable to simple trusts" resulted in an additional gift).

Other than for personal residence GRITs, the new valuation rules established by RRA '90 effectively require that the grantor's retained interest be in the form of an annuity in order to decrease the gift tax value of the remainder. That requirement eliminates the potential abuse associated with GRITs that did not earn a "reasonable rate of return."

With a personal residence GRIT, no income is generated. Accordingly, any appreciation in value of the residence during the retained interest term inures solely to the benefit of the remainder beneficiaries. This contradicts the assumptions made in valuing the remainder interest (i.e., that increases in value up to the discount rate were being distributed to the grantor). It is as if the assumed income being generated by the Section 7520 rate is being returned to the trust and not distributed.

EXAMPLE: A personal residence worth $1 million is transferred to a GRIT. The grantor retains the right to the income for ten years. If the gift tax valuation rate is 6.80%, the gift tax value is $517,950 (i.e., $1,000,000 × [1/(1 + .068)^{10}]). No income is paid to the grantor at the end of each year. Accordingly, if appreciation equals the gift tax valuation rate, the property would grow at 6.80% annually. At the end of ten years, the FMV of the property at a 6.80% growth rate would be $1,930,690 (i.e., $1,000,000 × [1 + .068]^{10}). Therefore, $930,690 passes to the remainder beneficiaries free of any transfer tax.[31]

Valuation of the reversionary interest. In addition, the grantor's retention of a reversion or general power of appointment during the retained interest term further decreases the value of the remainder interest for gift tax purposes, but results in no additional property flowing to the grantor. From a conceptual standpoint, the retained interest consists of another valuable property right, the right to receive principal back if the grantor dies during the retained interest term.[32]

EXAMPLE: The grantor, age 75, transfers a personal residence worth $1 million to a GRIT, retaining an income interest for five years. The income will be paid to her probate estate if she dies prior to the end of this term. The value of the remainder interest, at an assumed interest rate of 8.20%, is $674,316 (i.e., $1,000,000 × [1/(1+.082)^5]). If, however, the grantor had retained the right to receive income for a period ending with the first to occur of her death or the expiration of five years and a reversionary interest if she dies prior to the expiration of five years, the value of the remainder interest is only $512,632, as shown in Exhibit I on page 236. In the latter situation, the remainder interest, which is the discounted present value of the right to receive $1 million at the first to occur of five years in the future or the grantor's death, is decreased by the risk that the remainder interest will not be received if the grantor dies during those five years. Accordingly, the gift of the remainder interest has been decreased by $161,684, resulting in a decrease in the gift tax payable. The value of $512,632 five years in the future at a growth rate of 8.20% is $760,225 (i.e., $512,632 × [1 + .082]^5). Therefore, the retention of a reversion has resulted in $239,775 ($1,000,000 less $760,225) more in property passing to the remainder beneficiaries without being subjected to gift tax.[33]

The anti-estate-freeze rules of Section 2702 do not apply to interests in a personal residence.

Because the reversion is given a value, and in light of the possibility of appreciation, a personal residence GRIT provides transfer tax savings opportunities.

EXAMPLE: Penelope, age 60, is willing to relinquish the right to use her personal residence after ten years. Accordingly, Penelope retains both the right to use the residence for the next ten years and a reversion to her estate if she should die prior to the expiration of ten years. The value of the residence transferred to the GRINT is $500,000 and the Section 7520 rate for the month of the proposed transfer is 10.80%. Pursuant to the valuation rules in Reg. 25.2512-5, the value of the remainder interest for each $1 transferred to this type of GRINT is .2923, or $146,150 for the $500,000 transferred (see Exhibit II on page 237). Penelope would thus have gift tax exposure on a gift of only $146,150, even though the value of the residence was $500,000. By retaining the right to use the property for ten years, Penelope would be treated as owning an interest valued at $353,850. At the end of the ten years, the value of the residence, including any appreciation, passes to the remainder beneficiaries free of additional gift or estate taxes.

Market factors. Since the late 1980s, substantial regions of the U.S. have not experienced appreciation in residential real estate, and many have seen declines in value. Those results are to be contrasted with the tremendous appreciation in the residential real estate market experienced in the early 1980s. Accordingly, the practitioner cannot predict with confidence the value of the residence at the end of the retained interest term. The conservative transfer tax planning strategy requires that the possible savings be analyzed under three assumptions—no appreciation, appreciation equal to the inflation rate, and more substantial appreciation such as the Section 7520 rate used for gift and estate tax purposes.

If the practitioner believes the property is likely to depreciate, the personal residence GRIT is not a technique to pursue. Even if the residence does not increase in value, however, there still could be transfer tax savings compared with an outright gift. If the investment return rate for alternative investments during a ten-year period averages 10.80% and the transfer of $146,150 in the above example had been made in cash it would be worth $407,565 at the

[31] This analysis does not include as transfer tax savings the difference between $1 million and $517,950; had there been an outright gift of $517,950 in year 1 instead, it would have yielded (at the same assumed 6.8% discount rate) $1 million ten years in the future to the donees.

[32] Theoretically, that value is the (1) probability of death during the retained interest term multiplied by (2) the value of the GRIT property and then (3) discounted to present value using the assumed discount rate.

[33] Alternatively, compare the remainder component with and without the reversion. With the reversion, the remainder component is decreased by .161684 (i.e., .674316 − .512632) of the property initially transferred, or $161,684 (.161684 × $1,000,000). Since the reversion does not occur, the $161,684 is essentially property that passes to the remainder beneficiaries free of transfer tax. The value of $161,684 five years in the future at an assumed 8.20% growth rate equals $239,775.

Exhibit I: Comparison of GRIT With and Without Reversionary Interest

Value of remainder interest if (1) grantor retains an income interest for the entire five-year term versus (2) grantor retains an income interest for first to occur of the expiration of the five-year term and death, and retains a reversion if death occurs during the retained income term. The assumed interest rate is 8.2%. The grantor's age is 75 years. All calculations are pursuant to IRS Publication 1457 (8/89). Some numbers are rounded to the next decimal place where appropriate.

Retained income interest only

The value of the income and remainder interests are calculated as follows:

1. Table B, p. 3-16 , column (3), 8.2%, five-year term income factor = .325684
2. Table B, p. 3-16, column (4), five-year term remainder factor = .674316
3. Value of remainder interest = $1,000,000 × .674316, or $674,316.

Retained income interest with reversion if death occurs during retained income term

1. The value of the income interest—the right to receive the income until the first to occur of death or the end of five years—is calculated as follows under Table H (8.2%):

N factor, age 75	948.7018
Less: N factor, age 80 (the latest time the income interest may terminate)	(404.2715)
	544.4303
Divided by: D factor (age 75)	153.9204
Annuity factor	3.53708995
Required income factor = annuity factor × interest rate (.082) =	.2900413

2. The value of the reversionary interest—the right to receive the principal if the grantor dies during the first five years of the trust—is calculated as follows:

M factor (age 75)	76.12683
Less: M factor (age 80)	(45.75423)
	30.3726
Divided by: D factor (age 75)	153.9204
Reversion factor	.1973266

3. The gift tax value of the transfer of $1 million to the trust is $1 million multiplied by [1 minus the value of the grantor's retained interests], where the retained interests are (a) the right to receive the income until the first to occur of death or the end of the five year term and (b) a reversion if death occurs in the first five years:

$1,000,000 × [1 – .2900413 – .1973266] = $512,632

end of ten years (i.e., \$146,150 × [1 + .108]^{10}). Nevertheless, as the value of the residence remains at $500,000, $92,435 has passed to the remainder beneficiaries free of any transfer tax cost because of the GRIT. This occurs because the value of the retained interest was increased by the value of the reversion—as the grantor did not die during the retained interest term, the reversion did not occur and added no real value to the retained interest.[34]

Potential Disadvantages

The downside risk from the use of a GRIT can be measured in terms of opportunity lost. Although practitioners tend to present the GRIT strategy as a win-tie situation to clients, this is incorrect from an economic perspective. (As a practical matter, however, the win-tie presentation may be accurate if the client would not be willing to make other gifts. Then, except for the administrative costs of establishing the GRIT, there are no opportunity costs.)

If the retained interest holder dies during the retained interest term, the property is included in the gross estate. No loss, the practitioner may conclude, since the property would have been in the client's estate anyway, had it not been transferred to the GRIT in the first place. This conclusion ignores opportunity costs. If an outright gift had been made in year 1 rather than a remainder interest in a GRIT, the outright gift may have increased in value between the time of the gift and the death of the grantor. That appreciation would have inured to the benefit of the donees and not been included in the grantor's gross estate.

EXAMPLE: F transfers a personal residence worth $1 million to a five-year GRIT and is treated as having made a gift of $512,632 (see Exhibit I). M gives marketable securities worth $512,632 to her children. F and M were willing to make these taxable gifts because the tax was offset by the unified credit. F and M both die in year 4. The gifts have increased in value by 10% per year. F's residence, including the appreciation, is back in F's gross estate for estate tax purposes. M's gift of the securities, however, does not come back to M's

Exhibit II: Computations for Ten-Year GRIT With Reversionary Interest

Value of remainder interest if grantor retains an income interest for the first to occur of the expiration of the ten-year term or the grantor's death, with a reversion to the grantor's estate if death occurs during the ten-year term. The interest rate is 10.80%. The grantor's age is 60 years. All calculations are pursuant to Table H (10.80) in IRS Publication 1457 (8/89). Some numbers are rounded to the next decimal place where appropriate.

1.The value of the income interest—the right to receive the income until the first to occur of death or the end of ten years—is calculated as follows:

N factor (age 60)	13039.71
Less: N factor (age 70, the latest time the income interest may terminate)	(3189.434)
	9850.276
Divided by: D factor (age 60)	1780.224
Annuity factor	5.5332
Required income factor = annuity factor × interest rate (.1080) =	.5976

2. The value of the reversionary interest—the right to receive the principal if the grantor dies during the first ten years of the trust—is calculated as follows:

M factor (age 60)	371.9358
Less: M factor (age 70)	(175.9045)
	196.0313
Divided by: D factor (age 60)	1780.224
Reversion factor	.1101

3. The gift tax value of the transfer of $500,000 to the trust is $500,000 multiplied by [1 minus the value of the grantor's retained interests], where the retained interests are (a) the right to receive the income until the first to occur of death or the end of the ten-year term and (b) a reversion if death occurs in the first ten years:

$$\$500{,}000 \times [1 - .5976 - .1101] = \$146{,}150$$

estate, and M has effectively transferred the appreciation at no transfer tax cost. The transfer tax advantage over F amounts to $312,967, the property that will escape tax in M's estate, calculated as $([\$512{,}632 \times (1 + .1)^5] - \$512{,}632)$.

Furthermore, an asset given outright may appreciate at a substantially greater rate than the appreciation in a personal residence. Thus, the grantor conceivably could be in a more beneficial transfer tax situation by making an outright gift than by using a personal residence GRIT. As a result, the transfer tax effectiveness of a GRIT must be compared with the potential alternative. The discussion below assumes that, as is often the case, entering into the GRIT transaction will preclude the alternative strategy.

EXAMPLE: The value of a residence transferred to a GRIT is $500,000 when 120% of the federal midterm rate is 6.80%. The grantor, age 60, retains the right to use the residence for five years. Accordingly, the value of the remainder interest is $331,405 (see Exhibit III on page 238). If the property does not appreciate, its value in five years remains at $500,000.

If instead of a gift of a remainder in the personal residence, the grantor made a cash gift of an equal gift tax value—$331,405—that amount, if properly invested, could exceed the value of the personal residence in five years, provided the asset appreciates at a sufficient rate. For example, if the entire fund is invested in stock that appreciates at 9%, at the end of five years the stock would be worth $509,908 (i.e., $\$331{,}405 \times [(1 + .09)^5]$). On these facts, the outright cash gift provides more transfer tax benefits than the personal residence GRIT.

This comparison does not take into account a further disadvantage to the personal residence GRIT—inherent taxable gain in the property. The remainder beneficiaries generally will assume the donor's basis, possibly adjusted by gift tax paid.[35] As a result, after the payment of income taxes related to this inherent gain, the remainder beneficiaries, in an economic sense, have less property than the apparent market value indicates.

A further disadvantage of the personal residence GRIT is the loss of the step-up in basis that otherwise would apply under Section 1014 if the property were distributed at the owner's death. This could result in the payment of capital gains tax that might be avoided if the property were not transferred to the GRIT. For example, if the residence has a value at the end of the retained interest term of $500,000, and the carryover basis is $50,000, there is unrealized capital gain of

[34] Moreover, if the residence increases in value during this period, that increase is also a transfer-tax-free gain to the remainder beneficiaries.

[35] Section 1015(a). See also Ltr. Rul. 9109027.

Exhibit III: Computations for Five-Year GRIT With Reversionary Interest

Value of remainder interest if grantor retains income interest for first to occur of expiration of five-year term and death, and retains reversion if death occurs during retained income term. The interest rate is 6.80%. The grantor's age is 60 years. All calculations are pursuant to Table H (6.80) in IRS Publication 1457 (8/89). Some numbers are rounded to the next decimal place where appropriate.

1. The value of the income interest—the right to receive the income until the first to occur of death or the end of five years—is calculated as follows:

N factor (age 60)	15936.34
Less: N factor (age 65, the latest time the income interest may terminate)	(9507.908)
	6428.432
Divided by: D factor (age 60)	1616.535
Annuity factor	3.9767
Required income factor = annuity factor × interest rate (.0680) =	.2704

2. The value of the reversionary interest—the right to receive the principal if the grantor dies during the first five years of the trust—is calculated as follows:

M factor (age 60)	532.8640
Less: M factor (age 65)	(424.8888)
	107.9752
Divided by: D factor (age 60)	1616.535
Reversion factor	.06679

3. The gift tax on the transfer of $500,000 to the trust is $500,000 multiplied by [1 minus the value of the grantor's retained interests], where the retained interests are (a) the right to receive the income until the first to occur of death or the end of the five-year term and (b) a reversion if death occurs in the first five years:

$500,000 × [1 − .2704 − .06679] = $331,405

$450,000 that will result in tax of $126,000 when the property is sold. Had the grantor instead owned the property at his death, that tax could have been avoided.[36]

Commentators have suggested that the inherent capital gain problem can be mitigated by the retention of grantor trust status for income tax purposes at the expiration of the retained interest term. The property would thereafter be sold from the trust back to the grantor.[37] Accordingly, cash equal to the value of the residence would flow to the remainder beneficiaries, without any capital gains tax. For example, the GRIT could provide that the grantor retains an interest for five years, after which the property remains in trust for the benefit of the grantor's children. The grantor, though not a trustee (which would be of concern under Sections 2036 and 2038), would retain the power to reacquire the trust corpus by substituting other property of equivalent value. Under Section 675(4), that power arguably renders the trust a grantor trust after the expiration of the retained interest.[38] The power should not be a retained interest under Sections 2036(a)(2) or 2038, however.[39] If, after the expiration of the retained interest, the trust sells the personal residence to the grantor, the grantor incurs no capital gains tax and the remainder beneficiaries have the benefit of cash proceeds equal to the full value of the residence at that time.[40]

Conclusion

The personal residence GRIT provides an opportunity for transfer tax savings. On a less tangible level, a donor is often more willing to make a gift involving a personal residence than other family assets simply because the residence does not produce income. Planners should understand both the potential benefits and downside of the personal residence GRIT strategy. ■

[36] Also, had the property instead been sold by the grantor during life, the one-time capital gain exclusion under Section 121 (if available) could have avoided gain to the extent of $125,000. As a general rule, a gift of high-basis assets is always preferable, to avoid unrealized capital gain that is not taken into account in valuing the gift for gift tax purposes.

[37] See, e.g., Doyle, "Planning and Drafting a Qualified Personal Residence Trust," The Southern California Tax and Estate Planning Forum. There should be no capital gains in a sale between a grantor and a grantor trust. Rev. Rul. 85-13, 1985-1 CB 184 (transfer of trust assets to a grantor who owns the entire trust is not recognized as a sale for income tax purposes); *cf.* Rothstein, 735 F.2d 704 (CA-2, 1984).

[38] See Ltr. Rul. 9239015.

[39] It is uncertain whether the Service would argue that this is a Section 2036(a)(1) power. If the grantor has retained the right to reacquire the transferred property, the grantor has retained the possibility of the "enjoyment" of the transferred property. *Query* whether this is enough for includability under Section 2036(a)(1). See Estate of Linderme, Sr., 52 TC 305 (1969).

[40] *Cf.* Rothstein, *supra* note 37. This approach has not been the subject of any ruling or tested in court. Prudence dictates proceeding conservatively when discussing this strategy with clients.