Family Tax Planning Forum

By Robert S. Keebler

101-Year GRATs

The conventional wisdom has long been that the shorter the term of a GRAT can be set, the more effective the GRAT will be. There are two reasons for this. First, a short term minimizes mortality risk. In addition, the shorter the term, the fewer low returns in some years net out high returns in other years, increasing the amount of the tax-free transfer when multiple GRATs are created. It appears that very long-term GRATs will often produce even better results in times of low Code Sec. 7520 rates.[1]

The GRAT Inclusion Amount Regulations

Before the regulations were issued, the IRS took the position that if the settlor of a GRAT died before the end of its stated term, the amount included in the gross estate could be determined under either Code Sec. 2039 or Code Sec. 2036.[2] Because Code Sec. 2039 always included the full date of death value of the trust assets, taxpayers almost invariably created short-term GRATs to make sure the grantor survived the trust term. It was generally assumed that if the grantor died during the trust term, the GRAT would produce no transfer tax benefit.

Regulations issued in 2008 dropped the Code Sec. 2039 argument and took the position that only Code Sec. 2036 applied. The Code Sec. 2036 inclusion amount under the regulations is the lesser of (1) the date of death value of the trust assets, or (2) the amount of corpus necessary to pay the GRAT annuity in perpetuity.[3]

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Applying the Formula

The amount of corpus necessary to pay the GRAT annuity amount in perpetuity is simply the amount of the annual annuity payments (P) divided by the Code Sec. 7520 rate in effect on the grantor's date of death. The regulations provide an example in which the inclusion amount is less than the value of the trust assets on the date of death.

Facts

- Decedent (D) transfers $100,000 to a GRAT.
- GRAT term is 10 years.
- Annual GRAT is $12,000, payable in monthly installments.
- D dies during trust term.
- Value of GRAT assets on date of death is $300,000.
- Code Sec. 7520 rate on date of death is six percent.

Calculation

- The amount included in gross estate is the lesser of $300,000, or $12,000/0.06 = $200,000.
- The $200,000 amount must be multiplied by the monthly adjustment factor from Table K (1.0272) to produce a final value of $205,440.
- The amount included in the gross estate under Code Sec. 2036 is $205,440, substantially less than the full value of assets on D's date of death.

Two Ways GRATs Can Produce Tax-Free Transfers

Following issuance of the regulations, GRATs can produce tax-free transfers in either of two ways:
1. The grantor survives the trust term and money is left in the GRAT at the end of its term because the growth rate of the trust assets exceeded the Code Sec. 7520 rate.
2. The grantor dies during the trust term and the estate inclusion amount under Code Sec. 2036 is less than the fair market value of the trust assets.

Initial Reaction of Commentators

Although the example in the regulations reproduced above showed an inclusion amount less than the date of death value of the trust assets, commentators were quick to point out that the GRAT in the example was very different from GRATs in common usage. The term

was much longer and the GRAT was not zeroed out. Assuming that the Code Sec. 7520 rate on the date of death was the same as the Code Sec. 7520 rate on the date the GRAT was created, it would be almost impossible for the inclusion amount under the formula to be less than the value of the GRAT assets on the date of death for the typical two- or three-year GRAT. Table 1 shows the rate of return necessary for the inclusion amount under the formula to be less than the value of the GRAT assets on the date of death assuming a 1.4-percent Code Sec. 7520 rate both on the date the GRAT was created and on the grantor's date of death.

Table 1.

Term	Growth Required	Annual Payout	2036 Inclusion Amount (Payout/0.014)
2 years	529.9%	$510,517	$35,954,983
3 years	206.3	342,712	24,136,717
5 years	71.14	208,478	14,682,808
10 years	27.9	107,861	7,596,496

Longer Trust Terms and Increasing Code Sec. 7520 Rates

If we look at the GRAT inclusion amount formula, it is easy to see that the lower the annual payout rate and the higher the Code Sec. 7520 rate on the date of death, the lower the inclusion amount will be. The annual payout percentage is a function of two variables, the trust term and the Code Sec. 7520 rate on the date the trust is created. The lower the Code Sec. 7520 rate and the longer the trust term, the lower the payout percentage is. Thus, the ideal situation for creating a large tax-free transfer is one in which (1) the GRAT has a very long term, (2) the Code Sec. 7520 rate is very low when the GRAT is created, and (3) the Code Sec. 7520 rate has increased substantially by the time the grantor dies. Under these facts, a GRAT can produce a large tax-free transfer even if the rate of return on the trust assets does not beat the Code Sec. 7520 rate.

Example 1. In October 2012, when the Code Sec. 7520 rate is 1.2 percent, Amanda transfers $1 million to a 101-year zeroed-out GRAT. The annual annuity payment necessary to zero out the GRAT is $17,137. Amanda dies the day after the 10th payment is made and the Code Sec. 7520 rate on the date of death is five percent. The trust assets have grown at zero percent, so the value of the

trust on the date of death is $828,863 ($1,000,000 – [10 × $17,137]). The inclusion amount under the Code Sec. 2036 regulations is $17,137/0.05 = $342,740. As a result, there is a tax-free transfer of $486,123 to the GRAT remaindermen.

If the trust assets do beat the Code Sec. 7520 rate, the tax-free transfer can be substantially larger.

Example 2. Assume the same facts as in Example 1 except that the GRAT assets produce a return of seven percent. The value of the trust assets on the date of death is now $1,730,379. The inclusion amount under the Code Sec. 2036 regulations is again $342,740, producing a tax-free transfer of $1,387,639 ($1,730,379 – $342,740).

Does a Bet-to-Die GRAT Beat a Shorter-Term Bet-to-Live GRAT?

While a comprehensive analysis of when a 101-year GRAT will produce a larger tax-free transfer than a short-term bet-to die GRAT is beyond the scope of this column, there are clearly situations in which the 101-year GRAT will be more favorable. Under the general fact pattern presented above, a 101-year GRAT is far superior as shown in the following examples.

Example 4. Assume the same facts as in Example 1 except that Amanda creates a 10-year GRAT instead of a 101-year GRAT. The payment necessary to zero out the GRAT would be $106,718. The amount left in the GRAT at the end of its 10-year term would be $492,688. This is $894,951 less than the $1,387,639 tax-free transfer for the 101-year GRAT in Example 2.

Example 5. Assume the same facts as in Example 4, except that Amanda creates a two-year GRAT instead of a 10-year GRAT. The payment necessary to zero out the two-year GRAT would be $509,018. After two years, the value of the GRAT will be $91,032. The value of the 101-year GRAT will be $1,109,426. After reducing this by the formula amount, the tax-free transfer will be $766,686.

It may be interesting to look at the mathematics of the comparison. There is a trade-off between the tax-free transfer in a 101-year GRAT and a shorter-term bet-to-live GRAT. The full value of the trust assets will pass to the remaindermen at the end of the trust term in the case of the bet-to-live GRAT while this value will be reduced by the formula amount in the case of the 101-year GRAT. Which GRAT produces a larger tax-free transfer depends on whether the added growth in the 101-year GRAT is enough to offset the formula reduction.

Under the facts of Example 4, the terminal value of the 101-year GRAT was $1,730,379 and the terminal value of the 10-year GRAT was $492,688. Because of the far lower payouts, the 101-year GRAT had $1,237,691 more value. The formula reduction was only $342,740, leaving $894,951 more for the beneficiaries in the 101-year GRAT alternative.

Finally, because a series of short-term rolling GRATs may produce a larger tax-free transfer than a single GRAT with the same duration, planners may wish to use these GRATs in making the comparison.

Caveats

The following caveats should be noted:[4]

- Although long-term GRATs appear to be permissible under general tax principles, there is no specific authority approving them.
- The estate may have to remain open for the entire term of the trust.
- The grantor must plan so that the GRAT qualifies for the marital deduction.
  The Obama Administration has proposed making the maximum term for a GRAT the grantor's life expectancy plus 10 years.[5]

Conclusion

Record-low Code Sec. 7520 rates may create an opportunity to transfer large amounts of wealth tax-free with very long-term GRATs. Before using the strategy, however, planners should compare the expected benefit of a long-term GRAT with the expected benefit of shorter-term GRATs under their specific fact situations and carefully note the caveats listed above.

ENDNOTES

1. *See* Zaritsky and Aucutt, STRUCTURING ESTATE FREEZES (**<<DATE AND PUBLISHING INFO>>**), at ¶11.07[7].
2. LTR 9345035 (Aug. 13, 1993), LTR 9451056 (Sept. 26, 1994), LTR 9448018 (Aug. 30, 1994) and LTR 9707027 (Nov. 19, 1996); FSA 200036012 (May 25, 2000) and TAM 200210009 (Nov. 19, 2001).
3. T.D. 9414 (July 11, 2008) and Reg. §20.2036-1(c)(2).
4. Zaritsky and Aucutt, *supra* note 1.
5. Dept. of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals,* at 80.