

Checkpoint Contents

Federal Library

Federal Editorial Materials

WG&L Journals

Journal of Taxation (WG&L)

Journal of Taxation

2011

Volume 114, Number 05, May 2011

Articles

Generation-Skipping Transfer Tax Consequences of GRATs: Finding the Answers, Journal of Taxation, May 2011

*ESTATES, TRUSTS, & GIFTS*

## **Generation-Skipping Transfer Tax Consequences of GRATs: Finding the Answers**

***Author: By Austin W. Bramwell***

AUSTIN W. BRAMWELL is an associate in the trusts and estates department of Milbank, Tweed, Hadley & McCloy LLP. He is member of the New York State bar. The author thanks Jonathan G. Blattmachr for his helpful comments on this article, and Edward Heintzberger for his assistance with some calculations.

Copyright © 2011, Austin W. Bramwell.

*Practitioners familiar with the estate planning benefits of GRATs may not be giving sufficient attention to the impact of the GST tax on this vehicle. One of the most important aspects is to avoid wasting the grantor's available GST exemption.*

The grantor retained annuity trust (GRAT) <sup>1</sup> has in recent years become a popular estate tax planning technique. <sup>2</sup> GRATs combine several advantages. First, it seems that a GRAT can be created without the grantor making any more than a de minimis taxable gift. <sup>3</sup> Second, even if property transferred to a GRAT turns out to have been undervalued, the risk is slight that the grantor will be treated as having made a substantially increased taxable gift. <sup>4</sup> Third, a GRAT allows the grantor, through the retained annuity payments, to retain access to the property transferred to the GRAT. <sup>5</sup> Fourth, there is no tax downside if a GRAT fails to generate a remainder that passes free of gift and estate tax to the next generation, other than the (typically, very small) taxable gift made when the trust was created. <sup>6</sup>

Finally, GRATs can pass on wealth to the next generation even if the grantor does not know or cannot predict which of his or her assets will earn the highest returns. If the grantor has a portfolio of different assets, then, in any given short-term period, at least some of those assets may earn returns in excess of the interest rate determined under Section 7520 ("the Section 7520 rate"), which is the discount rate used to value the grantor's retained annuity interest for gift tax purposes. Over successive short-term periods, the probability that at least some assets will outperform the Section 7520 rate in at least one such period approaches 1. <sup>7</sup> Thus, if a taxpayer creates multiple short-term GRATs, each funded with a highly concentrated position, and pays over into new short-term GRATs the annuity payments received from his or her existing GRATs, then the GRATs as a whole almost certainly will pass on wealth to the next generation free of gift and estate tax, so long as the grantor survives the fixed terms. Given the virtual certainty of success, it is no wonder that both President Obama and members of Congress have proposed reforms that purport to curtail the effectiveness of GRATs. <sup>8</sup>

For all GRATs' well-deserved popularity, planners seldom focus on their generation-skipping transfer (GST) tax consequences. <sup>9</sup> Many advisors correctly understand that, generally speaking, GRATs are not good vehicles for transferring wealth to "skip" persons (e.g., grandchildren and more remote descendants). Nevertheless, they have seldom ventured to explain exactly why. Two questions in particular have been found especially vexing:

- (1) Is it possible to allocate GST exemption to a GRAT as of the date of initial funding? <sup>10</sup>
- (2) If an individual can allocate GST exemption as of the date of funding, how much must be allocated to produce an effective GST tax rate of zero?

[pg. 261]

This article aims to give definitive answers to these questions (beginning, for reasons that will become

clear, with the second). It also suggests some refinements to standard GRAT planning and drafting that should be considered in many if not most cases.

## HOW MUCH GST EXEMPTION TO PRODUCE AN INCLUSION RATIO OF ZERO?

Many planners wonder whether, if the "estate tax inclusion period" (ETIP) rules of Section 2642(f) do not prevent allocation of GST exemption as of the date of funding, the grantor can leverage the GST exemption by allocating it to a GRAT. The answer appears to be no. In brief, in order to create an effective GST tax rate of zero, a taxpayer must allocate to a GRAT an amount of GST exemption equal to the full value of the property contributed, without any reduction for the gift tax value of the grantor's retained annuity interest. Consequently, if the grantor allocates sufficient GST exemption to a GRAT to make it exempt from GST tax, the GST exemption allocated will be largely (if not entirely) wasted on annuity payments back to the grantor. It is therefore not efficient to have GST exemption allocated as of the date that a GRAT is funded.<sup>11</sup>

A review of the rules for calculating GST tax shows why. The GST tax rate is equal to the top estate tax rate multiplied by the "inclusion ratio."<sup>12</sup> The inclusion ratio, in turn, is defined as 1 minus the "applicable fraction."<sup>13</sup> The Code goes on to give two distinct definitions of "applicable fraction." For a direct skip transfer,<sup>14</sup> the applicable fraction (the "direct skip applicable fraction") is generally equal to the GST exemption allocated to the direct skip divided by the value of the property involved in the direct skip.<sup>15</sup> For a transfer to a trust (other than a direct skip transfer),<sup>16</sup> by

[pg. 262]

contrast, the applicable fraction (the "trust applicable fraction") generally is equal to the amount of GST exemption allocated to the trust divided by the value of the property transferred to the trust.<sup>17</sup> The efficiency for planning purposes of allocating GST exemption depends on which applicable fraction—the direct skip applicable fraction or the trust applicable fraction—applies to a gift to a GRAT.

As argued in further detail below, the applicable fraction for a GRAT is *always* the trust applicable fraction, not the direct skip applicable fraction. Under Section 2642(a), the direct skip applicable fraction applies only to "direct skip" transfers, i.e., transfers subject to gift or estate tax to skip persons as defined in Section 2613(a).<sup>18</sup> A GRAT, however, is never a skip person, as a non-skip person—the grantor—always has an interest in the GRAT during the fixed term. A transfer to a GRAT, therefore, can never be a direct skip, even if the remainder beneficiaries are all skip persons. Hence, the trust applicable fraction is the only applicable

fraction that can be used to calculate GST tax with respect to a GRAT.

To explain that conclusion in more detail: As noted above, Section 2612(c) defines a "direct skip" as a transfer to a skip person subject to gift or estate tax. Reg. 26.2612-1(a)(1) clarifies that a transfer to a trust is a direct skip only if the trust is a skip person. Thus, if a gift to a GRAT is (1) a transfer (2) to a trust and (3) the transferee is the GRAT, but (4) the GRAT is not a skip person, then the gift to the GRAT is not a direct skip transfer, and the direct skip applicable fraction cannot apply in calculating GST tax. Rather, the trust applicable fraction must apply. As discussed below, each of conditions 1 through 4 is satisfied when a gift is made to a GRAT.<sup>19</sup>

## One-Transfer

The first condition is that a transfer to a GRAT is a transfer for GST tax purposes. Under the Code and Regulations, an "individual shall be treated as transferring any property with respect to which such individual is the transferor."<sup>20</sup> An individual is the "transferor" of any property with respect to which he or she was subject to gift or estate tax.<sup>21</sup>

A transfer is considered to be subject to gift tax if a gift tax was imposed on such transfer, without regard to exemptions, exclusions, deductions, and credits.<sup>22</sup> Under this rule, if a gift is made to a GRAT that has not been fully zeroed out,<sup>23</sup> a gift tax will be considered to have been imposed on the value of the remainder interest. (The individual may have sufficient gift tax exemption to avoid liability for any gift tax, but the grantor's transfer is still considered to be subject to gift tax, as the gift tax exemption is ignored.) Therefore, as the grantor is considered to have been subject to gift tax with respect to the GRAT property, he or she becomes a "transferor" and a "transfer" occurs for GST tax purposes.

## Two-To a Trust

The second condition is that the transfer is to a trust. If condition 3 (discussed below) is satisfied, such that the "transfer" for GST tax purposes is considered to have been made to the GRAT, then the transfer is indeed to a trust. The Code and Regulations define "trust" broadly for GST tax purposes to include any arrangement that has substantially the same effect as a trust.<sup>24</sup>

A GRAT not only has the same effect as a trust, it *is* a trust. To begin with, it has all the traditional common law elements of a trust, namely:

- A trustee (i.e., the person to whom the property of the GRAT is transferred and who has fiduciary duties to administer the trust property according to the terms of the GRAT),
- A *res* (i.e., the property transferred to the GRAT),
- Beneficiaries (i.e., the grantor and the remainder beneficiaries designated in the trust instrument), and
- An intent to create a trust (i.e., the grantor's intent to create a trust for the benefit of the grantor and the remainder beneficiaries, as manifested in the language of the GRAT instrument).<sup>25</sup>

To be sure, for general tax purposes the Regulations define "trust" more narrowly.<sup>26</sup> For example, a "business trust," whereby associates use the trust as a device to carry on a

[pg. 263]

business together, is not generally treated as a trust for tax purposes.<sup>27</sup> In any event, while the general tax definition of "trust" is narrower than the common law definition, the GST tax definition of "trust" is broader. For example, trusts for GST tax purposes include arrangements "involving life estates and remainders, estates for years, and insurance and annuity contracts."<sup>28</sup>

A GRAT involves both an interest for a term of years<sup>29</sup> (i.e., the annuity interest retained by the grantor) and a remainder interest payable at the termination of the annuity interest. Thus, it involves both an "estate for years" and a "remainder." It is therefore a trust for GST tax purposes not only because it meets the traditional common law definition of "trust" but also because, even if meeting that definition were not sufficient, it still would have substantially the same effect as a trust.

A GRAT is required to be treated as a single trust for GST tax purposes (and not, for example, as separate "trusts" consisting of the annuity interest and the remainder interest). To be sure, the value of the taxable gift to a GRAT is calculated by subtracting the value of the grantor's retained annuity interest from the total value of the property transferred.<sup>30</sup> In that sense, a GRAT is treated for gift tax purposes as consisting of two pieces: a retained annuity interest and a remainder interest. A GRAT is treated differently, however, for GST tax purposes. Section 2654(b) provides that, except in narrow circumstances, "nothing in [the GST tax provisions] shall be construed as authorizing a single trust to be treated as 2 or more trusts." We have already seen that a GRAT is a trust for GST tax purposes. Unless a GRAT can fit into one of the exceptions to the general rule of Section 2654(b), therefore, it must be treated as a single trust for GST tax purposes.

Those exceptions are that (1) portions of a trust attributable to different transferors and (2) substantially separate and independent shares are treated as separate trusts.<sup>31</sup> A GRAT clearly has a single transferor

(i.e., the grantor) and therefore cannot be considered to consist of portions attributable to different transferors. A GRAT also does not consist of "substantially separate and independent shares." For a trust to consist of separate and independent shares, the shares must exist from the creation of the trust.<sup>32</sup> The annuity and remainder interests in a GRAT, however, are *successive* interests that do not both exist from creation.<sup>33</sup> Therefore, the general rule of Section 2654(b) applies and the GRAT is treated as a single trust for GST tax purposes.

## Three-GRAT is the Transferee

The third condition is that the transferee is the GRAT. As we have just seen, a GRAT is a single trust for GST tax purposes. Therefore, to the extent any transfer is made to a GRAT for GST tax purposes, the transfer must be treated as a transfer to the GRAT as a whole and not as separate transfers to one "trust" consisting of the annuity interest transferred to (or retained by) the grantor and to a second "trust" consisting of the remainder interest transferred to the remainder beneficiaries.

Some might deny, however, that by funding a GRAT the grantor actually makes any transfer to the GRAT for GST tax purposes. Rather, in their view, a transfer of property to a GRAT should be deemed to consist of one transfer (or retention) of an annuity interest and a second transfer of a remainder interest. The GRAT, according to this theory, never even becomes the transferee of any property for GST tax purposes. Instead, when the GRAT is funded, a remainder interest is transferred directly to the remainder beneficiaries and an annuity interest is retained by the grantor.

This position relies on a strained interpretation of the word "transfer." When a GRAT is created, no "transfer" of an annuity interest or a remainder interest literally takes place. Instead, the grantor transfers property to the trustee (or, perhaps, declares a trust of property), which in turn causes various interests (such as the annuity interest and the remainder interest) to arise in such property. Those interests, however, are not themselves "transferred" by any person. The case for treating the gift of the remainder interest in a GRAT as a "transfer" for GST tax

[pg. 264]

purposes thus defies the ordinary, lexical meaning of the word.<sup>34</sup>

In any event, the position is inconsistent with the Code and Regulations. The Code distinguishes between "property" and the various "interests" that may arise in such property. For example, whether a transfer of

property is immediately subject to GST tax depends on whether a non-skip person (such as a spouse, a child of the transferor, or the transferor) has an "interest" in such property, such as a right to income.<sup>35</sup>

Suppose that a grantor creates a trust in which her child has an annuity interest for a term of years and her grandchildren have the right to the remainder. In that case, the transfer is not a generation-skipping transfer triggering GST tax, as the transfer is to a trust and the trust is not a skip person.<sup>36</sup> Rather, a GST tax will be imposed on the termination of the fixed term.<sup>37</sup> The gift of the remainder interest to grandchildren, in other words, is not subject to GST tax, even though the remainder interest can in principle be valued just like the remainder interest in a GRAT.

In sum, the Code does not treat the transfer to the trust as consisting of one transfer of an annuity interest (not subject to GST tax) and a separate transfer of a remainder interest (subject to GST tax at the time of transfer). Rather, a single transfer is treated as having been made to a single trust, in which various interests may arise.<sup>38</sup>

Likewise, although a transfer to a GRAT creates an annuity interest and a remainder interest, the transfer should be treated as a single transfer to a single trust, namely, the GRAT. That the grantor is subject to gift tax on only the value of the remainder interest does not change this result. On the contrary, Reg. 26.2652-1(a)(1) states that the "transferor" for GST tax purposes is the individual "with respect to whom *property* was most recently subject" to gift or estate tax (emphasis added). Under this Regulation, the only thing that can be "transferred" for GST tax purposes is "property,"<sup>39</sup> not the various interests that may be created in such property when it is transferred. As discussed above, any property that is owned by a GRAT (as opposed the various beneficial interests in such property) was subject to gift tax, albeit only with respect to the value of the remainder interest. Therefore, the GRAT as a whole should be considered the transferee for GST tax purposes.

## **Four-GRAT Is Not a Skip Person**

The final condition is that the transferee-i.e., the GRAT-is not a skip person. A trust is a "skip person" only if all "interests" in the trust are held by skip persons.<sup>40</sup> An "interest" for GST tax purposes is a defined term that means, for an individual, either the right or the eligibility to receive income or corpus.<sup>41</sup>

The grantor of a GRAT is by definition an individual who has a right to receive income and/or corpus to the extent necessary to satisfy the retained annuity interest. With a GRAT, therefore, there always is a non-skip person who, during the fixed term, has an interest in the trust, namely, the grantor. Therefore, a GRAT

cannot be a skip person when it is initially funded.<sup>42</sup>

## Summary

Thus, when an individual makes a gift to a GRAT, he or she makes a transfer to a trust—namely, the GRAT—which can never be a skip person. Therefore, a gift to a GRAT is not a direct skip transfer, and, under Section 2642(a)(2), the "direct skip applicable fraction" does not apply. Instead, the "trust applicable fraction" applies. The "trust applicable fraction" is equal to the amount of GST exemption allocated to the trust divided by the value of the property transferred to the trust. As discussed, the "trust" in question is the entire GRAT, not the remainder interest in the GRAT. Therefore, the applicable fraction of a GRAT is equal to the amount of GST exemption allocated to the GRAT as a whole, divided by the value of all the property transferred to the GRAT, including

[pg. 265]

the value of the retained annuity interest.

**Example:** An individual funds a GRAT with \$1 million and retains the right to receive a series of annuity payments over the next ten years. The present value of the annuity payments is equal to \$999,000, so that the taxable gift is only \$1,000. The remainder after the ten-year annuity period is directed to be paid over to the individual's grandchildren (whose parents all are living at the time that the GRAT is created<sup>43</sup>). If the taxpayer allocates GST exemption as of the date of funding, how much must she allocate in order to cause the GRAT to have a zero inclusion ratio?

The answer is \$1 million. Once again, the applicable fraction is the GST exemption allocated to the GRAT divided by the value of all the property transferred. The value of the property transferred in this case is \$1 million. With a \$1 million denominator, the taxpayer must allocate \$1 million of GST exemption to achieve an applicable fraction of 1 and an inclusion ratio of zero.

An allocation of \$1 million of GST exemption to the GRAT in this example would be an extraordinarily inefficient use of GST exemption. After all, the taxpayer is entitled to a present value of \$999,000 from the GRAT in the form of annuity payments. She will receive those payments free of GST tax whether or not GST exemption is allocated, as a transfer from a trust back to the original transferor is not a generation-skipping transfer. Thus, to the extent that the taxpayer allocates GST exemption to the GRAT, it will be wasted on transfers that do not need to be shielded from GST tax. If it turns out that the GRAT

underperforms the Section 7520 rate and does not generate any remainder for her grandchildren, the grantor's allocation of \$1 million of GST exemption will not have saved GST taxes at all.

If only a small amount of GST exemption is allocated as of the date of transfer, the result is less catastrophic but hardly favorable. Suppose that the taxpayer allocates only \$1,000 of GST exemption to the GRAT. Once again, the GST exemption allocated will be largely wasted in the annuity payments returned to the grantor. Further, even if the GRAT is successful, the inclusion ratio will barely be reduced. The inclusion ratio of the GRAT will be equal to  $1 - (\$1,000/\$1,000,000)$ , or .999. Even if the GRAT is very successful, the allocation will have reduced the GST tax rate by a tenth of a percent.<sup>44</sup> In short, in no case is it a good idea to allocate GST exemption to a GRAT as of the date of initial funding.

Many may find this result counterintuitive. In the example above, the grantor makes a completed taxable gift of a remainder interest to her grandchildren. Yet the transfer to the GRAT is *not* a direct skip for GST tax purposes. In other words, an individual can make a taxable gift to skip persons without making a direct skip transfer to them.

Though paradoxical, the result is consistent with Congress's policy of limiting the use of split-interest trusts to leverage GST exemption. For example, Section 2642(e) creates a special rule for determining the inclusion ratio of a charitable lead annuity trust (CLAT).<sup>45</sup> Under that section, the denominator of the inclusion ratio is not determined until after charity's lead interest has terminated. Without this special rule, the denominator would be reduced by the value the taxpayer's charitable deduction for the value of the charity's lead annuity interest.<sup>46</sup> For example, but for the enactment of Section 2642(e), a grantor could transfer \$1 million to a CLAT in which a charity had a right to a series of annuity payments over ten years. If the present value of the annuity payments was \$999,000, the taxable gift to the grandchildren would be only \$1,000. Thus, the grantor could create a zero inclusion ratio by allocating merely \$1,000 of GST exemption to the CLAT. The "normal" GST tax rules produce results for GRATs that are similar to those that the special rule of Section 2642(e) now produces for CLATs.<sup>47</sup> In both instances, the grantor must wait until the fixed term ends to see how effective an allocation of GST exemption will be.

## **IS IT POSSIBLE TO LEVERAGE DIRECT SKIP TRANSFERS WITHOUT ALLOCATING GST EXEMPTION?**

Taxpayers' inability to allocate GST exemption to the remainder portion of a GRAT is not the most fundamental reason that GRATs make poor GST tax planning vehicles. Suppose, for example, that an

individual creates a nearly zeroed-out GRAT whose remainder at the end

[pg. 266]

of the fixed term is payable solely to grandchildren whose parents are living at the date the GRAT is created. In funding the GRAT, the grantor makes a small taxable gift to his or her grandchildren. If this gift were also a direct skip transfer, then the grantor would incur a small amount of GST tax. Many individuals would gladly pay a few hundred dollars of GST tax for the privilege of using GRATs to pass wealth down to grandchildren and more remote descendants. The ability to allocate GST exemption to the remainder portion, in other words, would not be necessary to leverage generation-skipping transfers to GRATs in the same manner that taxpayers already may leverage taxable gifts to GRATs.

The flaw in this plan is that a transfer to a GRAT can never be a direct skip. As argued in the first part of this article, the "transfer" for GST tax purposes is not to the remainder beneficiaries of a GRAT when it is created but rather to the GRAT as a whole. A GRAT, however, is never a skip person, because a non-skip person-the grantor-always has an interest in the GRAT during the fixed term. A transfer to a GRAT, therefore, can never be a direct skip, even if the remainder beneficiaries are all skip persons.

Instead, when the fixed term ends, a "taxable termination" subject to GST tax will occur. A "taxable termination" is generally the termination of an interest in property held in trust, unless a non-skip person has an interest in such property or at no time after the termination may a distribution be made to a skip person.<sup>48</sup> If the grantor, who is a non-skip person, survives the fixed term, his or her annuity interest will terminate. The grandchildren at that time still will be skip persons with respect to the grantor, as no direct skip or other generation-skipping transfer will have previously occurred to cause the grantor to be deemed to have "moved down" a generation, under Section 2653(a).

Thus, at the end of the fixed term, no non-skip person will have an interest in the trust and all property of the trust will be paid over entirely to skip persons, i.e., the grandchildren. The termination of the grantor's annuity interest, therefore, will constitute a taxable termination. (If the grantor does not survive the fixed term, whether a taxable termination occurs will depend, under the "look through" rule of Section 2651(f), on whether any beneficiary of the grantor's estate is a non-skip person.) The amount subject to GST tax generally will equal the entire value of the GRAT at that time.<sup>49</sup>

## **WHAT IF A NON-SKIP-PERSON REMAINDERMAN MAKES A GIFT OR SELLS THE REMAINDER INTEREST?**

Many planners have wondered whether it is possible to avoid the application of GST tax to GRATs by arranging for the remainder beneficiary, who would initially be a non-skip person, to make a gift or sale of that remainder interest.

**Example:** A grantor creates a nearly zeroed-out GRAT for a period of years and directs that the remainder at the end of the fixed term be paid over to the grantor's daughter or her estate. The trust instrument does not contain a "spendthrift" provision prohibiting beneficiaries from transferring their interests. Shortly after the GRAT is funded, the daughter makes a gift of her remainder interest to her own children, who are skip persons with respect to the grantor but not with respect to the grantor's daughter. If the Service concedes that the daughter becomes the transferor for GST tax purposes of the entire remainder interest, it would appear that, on the expiration of the fixed term, the entire then-value of the remainder would pass free of GST tax to the grantor's grandchildren.

The IRS has already refused to make this concession in the context of CLATs. In Ltr. Rul. 200107015, a child of the grantor who was entitled to a share of the remainder of a CLAT transferred her remainder interest to her own children. The IRS ruled that the original transferor remained the transferor with respect to all the CLAT property, other than a portion equal to the present value (as of the date of assignment) of the child's remainder interest. As the present value of the child's remainder interest as of the date of assignment was apparently quite small, the GST tax advantages of the strategy were, under the Service's holding, trivial at best. The IRS justified its conclusion in Ltr. Rul. 200107015 on the grounds that taxpayers should not be permitted to circumvent the special rule of Section 2642(e), which (as discussed above) is designed to prevent GST tax leveraging of CLATs.

The Service's focus on Section 2642(e) has led some planners to speculate that the rationale for refusing to bless a transfer of a remainder interest in a CLAT cannot be extended to the GRAT context, as there is no "special" rule for allocating GST exemption to GRATs. As we have seen, however, the GST exemption allocation rules are no more forgiving as applied to GRATs than as applied to CLATs. (If anything, they are even less forgiving: Unlike with GRATs, the GST exemption deemed allocated to a CLAT is increased during the fixed term by the interest rate used for determining the amount of the charitable gift tax deduction.<sup>50</sup> There is no similar rule available for GRATs.) As the general GST tax rules prevent the use of GRATs to leverage generation-skipping transfers, the rationale of Ltr. Rul. 200107015 cautions just as strongly (if not more so) against sales or gifts of remainder interests in GRATs as it does against sales or gifts of remainder interests in CLATs.

In any event, apart from policy-based arguments, the major obstacle to GST tax planning through a sale or gift of a remainder interest in a GRAT may be Reg. 26.2652-1(a)(5), Example 4. In that Example, an income beneficiary transfers an income interest to an unrelated party. The Example states that "[b]ecause [the transfer of the income interest] is a transfer of a term interest in the trust *that does not affect the rights of other parties with respect to the trust property*, [the original settlor] remains the transferor with respect to the trust." (Emphasis added.)

This may be one of the more mysterious Regulations in the GST tax area.<sup>51</sup> In particular, the meaning of the italicized clause ("that does not affect the rights of the other parties with respect to the trust property") is unclear. Arguably, it means that a transfer of a beneficial interest in a trust does not cause a change in the transferor for GST tax purposes, as a mere change in the identify of one of the beneficiaries does not in theory "affect the rights" of any of the other beneficiaries. If so, then a skip person who receives a beneficial interest in a trust-such as a remainder interest in a GRAT-from a non-skip person still will be a skip person with respect to the trust property. It would then not be possible to avoid GST tax by transferring beneficial interests in previously transferred property, such as a remainder interest in a GRAT.

## **IS IT POSSIBLE TO MAKE A DIRECT SKIP TRANSFER SUBJECT TO AN ETIP?**

This article argues that it is impossible to make a direct skip transfer to a GRAT because the grantor (a non-skip person) always has an interest in the GRAT during the fixed term, which will prevent the GRAT from being considered a "skip person." It might be objected that this conclusion is inconsistent with Reg. 26.2632-1(c)(1)(i). That Regulation provides that "[a] direct skip ... that is subject to an estate tax inclusion period (ETIP) is deemed to have been made only at the close of the ETIP."

An ETIP is generally any period during which any portion of the value of the transferred property could be included (other than by reason of Section 2035) in the gross estate of the transferor or the transferor's spouse.<sup>52</sup> Thus, the Regulation contemplates that a direct skip may occur even though the transferred property may be included in the transferor's gross estate.

Planners, perhaps, most often think of ETIPs as existing when a grantor retains a lead interest in a trust, such as the annuity interest in a GRAT or the income interest in a grantor retained income trust (such as a personal residence trust).<sup>53</sup> If one only focuses on ETIPs created by grantor retained lead interests, then one might be tempted to view Reg. 26.2632-1(c)(1)(i) as indirectly undermining the argument made in this

article.

According to this article, after all, if a grantor transfers property to a trust, retains a right to income for a term of years, and directs that the remainder be paid over to skip persons, no direct skip occurs because, by virtue of the grantor's lead interest, the trust cannot be considered a skip person. The transfer, however, is clearly subject to an ETIP, as the grantor's retained interest will cause the property of the trust to be included in the grantor's gross estate under Section 2036(a)(1). How then can a direct skip transfer ever be subject to an ETIP, as Reg. 26.2632-1(c)(1)(i) seems to assume is possible?

The answer becomes apparent when one looks beyond the canonical examples of transfers subject to an ETIP. A direct skip transfer subject to an ETIP can occur in each of the following cases:

**Case 1-Remainder interest in spouse.** A grantor creates a trust in which the grantor's grandchild (whose parents are still living) has an annuity interest for a term of years. The remainder at the end of the fixed term is payable to the grantor's spouse (who is a U.S. citizen) or the spouse's estate. The spouse's vested remainder interest qualifies for the gift tax marital deduction.<sup>54</sup> Thus, the amount subject to gift tax will be limited to the value of the grandchild's annuity interest, as the value of the spouse's remainder interest will be deducted from the grantor's total taxable gifts for the year.

Nevertheless, the trust appears to be a "skip person" trust for GST tax purposes, as the only person who has an interest in the trust during the fixed term is the grantor's grandchild, who is a skip person with respect to the grantor. (The spouse does not have an interest in the trust during the fixed term, as the spouse is not eligible or entitled to distributions.<sup>55</sup>) Consequently, it appears that the grantor's transfer to the trust meets the definition of a direct skip transfer. The direct skip also is subject to an ETIP, as the grantor's spouse's interest is includable in the spouse's gross estate under Section 2033.<sup>56</sup>

**Case 2-Reversionary interest in grantor.** A grantor creates a trust of \$5 million in which the grantor's grandchild (whose parents are still living) has a right to receive an

[pg. 269]

annual payment of \$5,000 for two years. The remainder at the end of the fixed term is payable to the grantor or the grantor's estate. The grantor's retained remainder interest is a qualified interest within the meaning of Section 2702(b)(3) and thus reduces the value of the taxable gift (if any). Meanwhile, the grandchild's annuity interest qualifies in its entirety for the gift tax annual exclusion under Section 2503(c).<sup>57</sup> Thus, the creation of the trust will not result in any gift for gift tax purposes.

Nevertheless, the trust appears to be a "skip person" trust for GST tax purposes, as the only person who has an interest in the trust during the fixed term is the grantor's grandchild, who is a skip person with respect to the grantor. (The grantor does not have an interest in the trust during the fixed term, not being eligible or entitled to distributions.<sup>58</sup>) Consequently, it appears that the grantor's entire transfer to the trust meets the definition of a direct skip transfer. The direct skip also is subject to an ETIP, as the grantor's reversionary interest is includable in the grantor's gross estate under Section 2033.<sup>59</sup>

**Case 3-Retained power to affect timing of income distributions.** A grantor creates a trust for a grandchild and directs that all principal and accrued income shall be paid over to the beneficiary at age 30. The grantor retains the right as trustee of the trust to accumulate or distribute income to the grandchild. The trust appears to be a "skip person" trust for GST tax purposes, as the only person who has an interest in the trust during the fixed term is the grantor's grandchild, who is a skip person with respect to the grantor. The direct skip also is subject to an ETIP, as the retained power to accumulate or distribute income makes the trust includable in the grantor's gross estate under Section 2036(a)(2).<sup>60</sup>

As these examples show, even though a transfer to a trust in which the grantor retains a lead interest cannot be a direct skip, it is still possible, as Reg. 26.2632-1(c)(1)(i) correctly assumes, to make a direct skip transfer subject to an ETIP. In short, the Regulation is not premised on the assumption that a transferor makes a direct skip transfer by making a taxable gift of a remainder interest to skip persons. On the contrary, as argued, such an assumption is inconsistent with other provisions of the Code and the Regulations.

Indeed, Reg. 26.2632-1(c)(1)(i) establishes that it is possible to make a taxable gift of even a lead interest solely to skip persons and still not be considered to have made a direct skip transfer. In Case 1, the trust is subject to an ETIP during the fixed term of the grandchild's annuity interest, as the grantor's spouse's remainder interest is includable in the spouse's gross estate under Section 2033. On the expiration of the fixed term, the property will be paid over to the grantor's spouse (if the spouse survives), at which point it once again will be includable in the spouse's gross estate under Section 2033. Consequently, if the grantor's spouse survives the fixed term, it seems that the ETIP will extend beyond the term of the grandchild's interest. As the ETIP outlives the grandchild's interest, it seems that the direct skip made on funding the trust may never be deemed to occur.

Similarly, in Case 2, the trust is subject to an ETIP during the fixed term of the grandchild's annuity interest, as the grantor's reversionary interest is includable in the grantor's gross estate under Section 2033 and/or Sections 2036(a)(1) or 2037. On expiration of the fixed term, the property will be paid over to the grantor (if

the grantor survives), at which point it once again will be includable in the grantor's gross estate under Section 2033. Thus, if the grantor survives the fixed term, it seems that the ETIP will extend beyond the term of the grandchild's interest. As the ETIP outlives the grandchild's interest, it seems that the direct skip made on funding the trust may never be deemed to occur.

Instead, the annuity payments made to the grandchild in Case 1 and Case 2 will be treated as taxable distributions as defined in Section 2612(b).<sup>61</sup> (Until a direct skip occurs, which, as discussed above, may be never, the transferor is not deemed to move down a generation under the rule of Section 2653(a). Thus, the skip person beneficiaries would remain skip persons during the fixed term of the trust.) In sum, just as it is possible to make a taxable gift of a remainder interest solely to skip persons yet not make a direct skip transfer, so it is also possible to make a taxable gift of a lead interest solely to skip persons yet not make a direct skip transfer.

The Regulation largely prevents what otherwise would be a troubling result in Case 2. In that example, very little wealth is actually passed on to the transferor's grandchild, yet the entire transfer meets the definition of a direct skip. Reg. 26.2632-1(c)(1)(i), however, appears to prevent the direct skip from occurring so long as the grantor survives the two-year term. Instead of the entire transfer to the trust being subject to GST tax, only the \$5,000 distributed to the grandchild each year during the fixed term will be subject to GST tax. Taxing the \$5,000 annuity payments that actually are paid to the grandchild rather than the entire trust seems much more consistent with the purpose of the GST tax, which is to tax wealth actually passing to skip generations.

Suppose, however, that the grantor does not survive the fixed term.

[pg. 270]

In that event, it would appear that, under the special rule of Reg. 26.2632-1(c)(1)(i), a direct skip of the entire property would be deemed to occur at death, triggering a large GST tax liability. Although this result-albeit in a highly artificial situation-is indeed troubling, it does not imply that there are exceptions to the general rule that, where property is transferred to a trust that is a single trust for GST tax purposes, the entire property is considered transferred.

There is no indication in the Code or Regulations (or any other binding authority) that the numerous technical definitions that implement the GST tax are subject to policy-based exceptions whenever they seem to create an unjust result. (On the contrary, the case law in the wealth transfer tax area is rife with examples of individuals being subjected to taxes that could easily have been avoided.<sup>62</sup>) For the most part,

the definitions, at least in the author's view, seem to work remarkably well.

Furthermore, policy-based arguments cut both ways. If the general rules may be construed to save taxpayers from harsh consequences, then, by the same token, they also should be construed to prevent loopholes from being opened. The possibility that the general rules produce unjust results in some instances, therefore, does not prevent the general rules from applying to GRATs in a way that limits taxpayers' ability to leverage GRATs for GST tax purposes.

## **CAN GST EXEMPTION BE ALLOCATED TO A GRAT AS OF THE DATE OF FUNDING?**

We now turn to whether it is possible for a taxpayer to allocate GST exemption to a GRAT as of the date of initial funding. Although it is not certain, it appears that in many cases the answer is yes. Only by convincing a court to invalidate Regulations could a taxpayer defeat an IRS argument that GST exemption was allocated to a GRAT as of the date of funding. As discussed below, it will be exceptionally difficult for any taxpayer to have the relevant Regulation struck down by the courts.

The view that taxpayers are prevented from allocating GST exemption to a GRAT, effective as of the date of funding, seems at first glance to follow straightforwardly from the Code. Section 2642(f) provides that if an individual makes an inter vivos transfer, and the value of the transferred property would be includable in the transferor's gross estate if the transferor died immediately thereafter, then an allocation of GST exemption "shall not" be made before the close of the ETIP (i.e., the earlier of the individual's death or the moment that the property would no longer be includable in his or her gross estate other than by reason of Section 2035). If an individual creates a GRAT, all or a portion of the value of the GRAT will be included in the grantor's gross estate under Section 2036(a)(1) if the grantor does not survive the fixed term. Therefore, it would appear that under Section 2642(f) it is impossible to allocate GST exemption to a GRAT until the grantor dies or the fixed term ends. Instead, if GST exemption is allocated to a GRAT before the fixed term, the allocation is irrevocable but not effective until the close of the ETIP.<sup>63</sup>

The Regulations, however, create an exception to this rule that appears to apply GRATs with relatively short fixed terms created by relatively young individuals. Reg. 26.2632-1(c)(2)(ii)(A) provides:

"[T]he value of transferred property is not considered as being subject to inclusion in the gross estate of the transferor ... if the possibility that the property will be included is so remote as to be negligible. A possibility is so remote as to be negligible if it can be ascertained by actuarial standards that there is less than a 5

percent probability that the property will be included in the gross estate."

Under this Regulation (the "5% probability rule"), the IRS apparently will ignore in some cases the fact that, if a taxpayer dies during the fixed term of a GRAT, some or all of the GRAT property will be included in the gross estate. Instead, if it can be determined actuarially that there is a less than 5% probability of gross estate inclusion ever happening-i.e., a less than 5% probability of death during the fixed term-then an allocation of GST exemption will be effective as of the date of funding.

The applicability of the 5% probability rule does not depend on the value of whatever interest the grantor may have retained to cause gross estate inclusion. For example, according to IRS actuarial tables,<sup>64</sup> a 70-year-old has a greater than 95% chance of surviving, say, two years. If even a relatively elderly transferor creates a short-term GRAT, therefore, the 5% probability rule may be satisfied, so long as the grantor is more than 95% likely to survive the fixed term, even though the grantor's retained annuity interest may be nearly equal to the value of the entire property transferred. It would appear, in other words, that in many if not most cases

[pg. 272]

it is possible to allocate GST exemption to a GRAT as of the date of creation.

Many planners feel that the 5% probability rule ought not to apply to GRATs. In their view, it would create a tax planning opportunity that Congress did not intend, as it would supposedly allow taxpayers, as of the date of initial funding, to allocate GST exemption only to the remainder of the GRAT. As we have seen, however, GST exemption can be allocated only to the entire value of the property transferred.

Consequently, an allocation of GST exemption almost always will go to waste in the form of annuity payments to the grantor. Seen in proper perspective, the Regulation not only does not create potential for abuse but opens up a trap for the unwary. It is a weapon in the hands not of taxpayers but the IRS.

Unfortunately, striking down the Regulation will be extremely difficult. Section 2663 directs Treasury to prescribe such Regulations as may be "necessary or appropriate" to carry out the purposes of the GST tax. In light of recent developments, it is likely that the GST tax Regulations will be given the highest levels of deference by the courts.<sup>65</sup> Consideration is given below to whether the Regulation reasonably resolves an ambiguity in the Code.

Section 2642(f) does indeed contain an ambiguity. By its terms, it prevents allocation of GST exemption if an individual "makes an inter vivos transfer of property" and "the value of such property would be includible

in the gross estate of such individual ... if such individual died immediately after making such transfer (other than by reason of section 2035)." The statute does not, however, explain what is meant by "the value" of transferred property. In particular, it does not say whether the ETIP rules apply only if the *full* value of transferred property is includable in the transferor's gross estate or whether the ETIP rules apply even if less than the full value is includable.

For example, if a grantor retains for life the right to only one-hundredth of a trust's income, only one-hundredth of the corpus would be includable in the grantor's gross estate under Section 2036.<sup>66</sup> Absent Regulations, it would not be clear whether it is possible for the grantor to allocate GST exemption to the trust as of the date of funding.

Another ambiguity is to what extent the ETIP rules apply to transfers in which the grantor has retained a reversionary interest. Under New York law, if a grantor does not make a complete disposition of trust property, then he or she has a reversionary interest in the trust.<sup>67</sup> The possibility of reversion to the grantor often will be so trivial as to be practically meaningless.

For example, a grantor with ten grandchildren might create a trust for the benefit of all her descendants for 21 years, remainder to her then-living descendants, and not provide for any alternate taker in case none of her descendants survives the term. Although the probability is very small, it is nevertheless possible that all the grantor's descendants will die before the term of the trust ends, in which case the trust property will revert to the grantor. The grantor or the grantor's estate, therefore, has a reversionary interest that theoretically should be included in the grantor's gross estate,<sup>68</sup> even though its value is extremely small. Section 2642(f) does not clearly indicate whether the grantor's de minimis reversionary interest prevents allocation of GST exemption, on the theory that at least some tiny portion of "the value" of the transferred property is includable in the grantor's gross estate.

Treasury and the IRS reasonably resolved this ambiguity with both a general rule and an exception. First, Reg. 20.2036-1(b)(1)(iii) clarified that if any part of a trust is subject to an ETIP, then the entire trust is subject to an ETIP. For example, if a grantor retains for life the right to only one-hundredth of a trust's income, it appears that the grantor could not allocate any GST exemption to the trust.

Second, to address the problem that not all retained interests should prevent lifetime allocation of GST exemption, Reg. 26.2632-1(c)(2)(ii)(A) added the 5% probability rule. That rule states that relatively remote possibilities should be disregarded for purposes of the ETIP rules. For example, a grantor might create a trust for a grandchild to age 25 but retain the right as trustee of that trust to accumulate or distribute income. The retained power will cause the trust to be included in the grantor's gross estate under Section

2036(a)(2).<sup>69</sup> If

[pg. 273]

the grandchild is already 21 years of age, the probability of gross estate inclusion may be very small. The 5% probability rule sensibly allows the grantor to allocate GST exemption to the trust, so that the GST exemption may shelter from GST tax all appreciation in the four-year period between funding and the date that the grandchild turns 25.

To be sure, the 5% probability rule is far from perfect. For one thing, it does not address the problem of remote reversionary interests that are theoretically includable in a transferor's gross estate. Even if a remote reversionary interest is virtually worthless, the probability that it will be included in a transferor's gross estate still may be substantially more than 5%. Indeed, if a grantor creates a trust for descendants, and the trust does not contain an "alternate takers" clause if all descendants are deceased, it is virtually certain that the grantor's reversionary interest (however minuscule in value) will be included in the grantor's gross estate.

That does not mean, however, that the 5% probability rule is unreasonable, much less arbitrary or capricious. At the very least, it does address the problem of very short lead interests. The rule's defects could be cured not by eliminating the rule but by adding another to cover retained interests of very little value.

In any event, as discussed, the 5% probability rule also appears to exempt from the ETIP rules a large number of GRATs, because in many instances the grantor will have a greater than 95% chance of surviving the fixed term. Consequently, many taxpayers may allocate GST exemption to GRATs as of the date of funding, with the result that GST exemption will be wasted in the form of annuity payments directly back to the transferor.

This result, though unfortunate, does not make the Regulation unreasonable. In its defense, as the government may first point out, the taxpayer is not necessarily harmed. In the worst case, a taxpayer allocates all the available GST exemption to transfers that would not have been subject to GST tax in the first place. The transferor is not subject to additional taxes as a result of the 5% probability rule.

Moreover, the government may say, it is not its job to adopt Regulations that guide taxpayers towards decisions that are viewed as efficient GST tax planning. Some taxpayers with very definite ideas of how their descendants will inherit wealth might not care to take full advantage of their GST exemptions. For

example, if a taxpayer decides to leave for her grandchildren no other wealth than a remainder interest in a GRAT funded with \$5 million, she may not mind allocating all her GST exemption to the GRAT as of the funding date. (Even with the best of planning, the trustees of a very successful, highly appreciated GST-exempt trust might decide to distribute all of the property to beneficiaries who are not skip persons.) In any event, taxpayers can avoid misallocations of GST exemption by simply not allocating GST exemption to GRATs in the first place.<sup>70</sup>

Second, the 5% standard is a common one in the wealth transfer tax arena. Under Sections 673(a), 2037(a), and 2042(2), taxpayers are saved from adverse consequences if the value of a reversionary interest is less than 5% of the total property. In contrast to these provisions, the 5% probability rule will in some instances-although not all-be unhelpful. Nevertheless, Congress has clearly indicated that 5% is a good place to draw the line when deciding whether relatively insignificant interests should have tax consequences.

Thus, Reg. 26.2632-1(c)(2)(ii)(A) almost certainly would be upheld. If the 5% probability rule is in fact valid, then many taxpayers who create short-term GRATs may allocate GST exemption as of the date of initial funding. Unfortunately, as discussed in the beginning of this article, it is almost never a good idea to allocate GST exemption to a GRAT during the fixed term. The Regulation, although it will likely be upheld, creates a trap for the unwary.

## **PLANNING IMPLICATIONS**

In light of the foregoing, planners should take proactive steps to prevent adverse GST tax consequences to clients who are considering or who have created GRATs. Some of these steps are described below.

### **Election Out of Automatic Allocation**

The planner should make absolutely sure that the grantor elects out of automatic allocation of GST exemption on a timely filed gift tax return for the year that a GRAT is created.

As discussed above, GST exemption should not be allocated to a GRAT as of the date of initial funding. Unfortunately, as also discussed above, the ETIP rules will not necessarily save taxpayers who mistakenly allocate GST exemption to GRATs. As if that were not bad enough, under Section 2632(c) GST exemption will

[pg. 274]

be automatically allocated up to the full value of the transferred property, effective as of the date of funding, to any GRATs that satisfy the 5% probability rule, unless the taxpayer makes an affirmative election out. To avoid wasting GST exemption, it is imperative that taxpayers affirmatively elect out of automatic allocation.

For example, suppose that an individual transfers \$5 million to a GRAT and directs that, at the end of a five-year fixed term, the remainder is to be held in a long-term trust for the benefit of all her children and grandchildren. If not more than 25% of the trust corpus must be paid over to the grantor (in the form of annuity payments) before she attains age 46, it appears that the GRAT will be deemed a "GST trust" within the meaning of Section 2632(c)(3)(b). If the GRAT is a GST trust, then unused GST exemption is automatically allocated to the GRAT to the extent necessary to make a zero inclusion ratio.<sup>71</sup> If the 5% probability rule applies, the allocation will be effective as the date of initial transfer. In other words, as much as \$5 million of GST exemption may end up being wasted in annuity payments to the grantor.<sup>72</sup> To prevent this result, the taxpayer must file a timely gift tax return for the year of the initial transfer in which she elects out of automatic allocation of GST exemption.<sup>73</sup>

## Use a Formula Withdrawal Clause

The planner could consider drafting a formula withdrawal clause that would prevent the automatic allocation rules from applying.<sup>74</sup>

Section 2632(c)(3)(B)(i) provides an exception to the automatic allocation rules that apply to "GST trusts" if more than 25% of corpus may be withdrawn by non-skip individuals before the date that such individuals attain age 46. This exception suggests that the automatic allocation rules may be defeated by conferring a power of withdrawal on non-skip beneficiaries, conditioned on an "election out" not having been made. Such a clause could be drafted as follows:

*Conditional power of withdrawal of non-skip persons.* If the automatic allocation rules of Section 2632(c) of the Code otherwise would, in the absence of this provision, apply to this trust (absent an election out of having such rules apply), and I fail to make a timely election not to have such rules apply, then each individual beneficiary of the Descendants' Trust created after the fixed term who is a non-skip person with respect to me, within the meaning of Section 2613(b) of the Code, shall have the power, exercisable beginning as of the forty-fifth (45th) birthday of the eldest such beneficiary then living, to withdraw from the

principal of the Descendants' Trust a percentage of the then net fair market value of the Descendants' Trust equal to the product of 25.01% and a decimal fraction obtained by dividing 1 by the total number of such descendants at that time. The purpose of this provision is to ensure that no automatic allocation of GST exemption under Section 2632(c) of the Code will occur with respect to this trust.

To prevent adverse gift and estate tax consequences, such powers of withdrawal should be drafted so as to lapse each year after such beneficiary attains age 45 by the greater of \$5,000 or 5% of the value of the trust.

<sup>75</sup> If the grantor does make an affirmative election out of the automatic allocation rules of Section 2632(c), then no beneficiary would have a power of withdrawal under the above provision.

## Specific Testamentary Gifts

The planner could consider having the grantor make specific testamentary gifts of the grantor's annuity interest in any GST-exempt GRATs.

Despite planners' best efforts, it is always possible that a client may end up allocating GST exemption to a GRAT. If the grantor dies during the fixed term, the applicable fraction of such a GRAT will not change as a result of the grantor's death. <sup>76</sup> For example, if a grantor creates a nearly zeroed-out GRAT funded with \$10 million and inadvertently allocates, effective as of the date of funding, \$5 million of GST exemption to it, the GRAT will have an inclusion ratio of 0.5. The grantor's estate would then become entitled to property from the GRAT (in the form of annuity payments) that is taxable at only half the top GST tax rate.

To prevent the favorable rate from being wasted (for example, by using the property to pay administration expenses or bequests to non-skip persons), <sup>77</sup> the grantor by will should make a specific bequest to skip persons (or to a long-term trust for descendants) of the grantor's annuity interest in any GRAT having an inclusion ratio of less than 1. <sup>78</sup> The

[pg. 275]

bequest of the annuity amount, even if it is made by the grantor directly to skip persons, should not require an allocation of additional GST exemption. <sup>79</sup>

To ensure this result, GRATs should be drafted so that the retained annuity interest of the grantor or the grantor's estate is freely assignable and not subject to a spendthrift provision. If the bequest is not effective, the Service may argue that the funds paid over to the estate from the GRAT could have been used by the grantor's executors to satisfy claims, pay administration expenses, fulfill bequests, etc., and therefore that

any bequest of GRAT funds is really a bequest of cash that is not partially or fully GST-exempt unless GST exemption is allocated to it. In effect, the IRS would argue that the payment of annuity amounts to the estate results in a new transferor, which in turn necessitates an allocation of additional GST exemption to keep the GRAT property partially or fully GST-exempt, just as if such property had been paid over to the grantor's estate from some other source. An effective bequest of the annuity interest (as opposed to the funds payable in satisfaction of the annuity interest) may foreclose this argument.<sup>80</sup>

## **Pay GRAT-Related Tax From Other Sources**

The planner should consider drafting the taxpayer's documents to direct the payment of estate taxes with respect to any fully or partially GST-exempt GRATs out of sources other than the GRATs.

Planners seldom consider how a decedent's estate will pay for estate taxes with respect to any outstanding GRATs. After all, GRATs typically provide that if the grantor dies during the fixed term, the remaining annuity amounts will be paid over to the grantor's estate, where they will be available for the payment of estate taxes. Consequently, few decedents specifically provide in their wills that their executors should pay all estate taxes with respect to outstanding GRATs out of (for example) the residue of their estates.

In many situations, this policy may be harmless.<sup>81</sup> Suppose, however, that a decedent dies during the fixed term of a GRAT. Under the equitable tax apportionment provisions of applicable state law,<sup>82</sup> the GRAT may be liable for its share of estate taxes, unless the decedent directs otherwise. If the decedent fails to direct that estate taxes with respect to the GRAT be paid out of another source, then the IRS may treat any satisfaction of the GRAT's estate tax liability from another source (such as the grantor's estate) as a constructive addition that reduces the applicable fraction.<sup>83</sup>

Consequently, it may be prudent to direct that all estate taxes with respect to trusts having an applicable fraction of less than 1 that are included in the grantor's gross estate are to be paid out of the decedent's residuary estate. Combined with a specific testamentary gift of any annuity interest in a fully or partially GST-exempt GRAT, such a provision will ensure that the property of the GRAT will remain fully or partially GST-exempt after the grantor's death.

## **CONCLUSION**

The GST tax consequences of GRATs are counterintuitive and present traps for the unwary. Planners

should take steps to ensure that GST exemption is not allocated to any GRAT as of the date of initial funding. As it is all too easy to allocate GST exemption to a GRAT, planners should also draft clients' GRATs and their wills so as to minimize the risks and downsides of an inadvertent allocation of GST exemption to a GRAT.

## Practice Notes

To prevent wasting the GST exemption on annuity payments that will be made to the grantor, the planner should make absolutely sure that the grantor elects out of automatic allocation of GST exemption on a timely filed gift tax return for the year that a GRAT is created. In addition, conferring a power of withdrawal on non-skip beneficiaries, conditioned on an "election out" not having been made, might be useful.

1

A GRAT is a trust in which the grantor retains the right to the payment of an annuity for a term of years. If the remainder is payable to or for the benefit of members of the grantor's family within the meaning of Section 2701(e)(2), and the interest retained by the grantor is a "qualified interest" within the meaning of Section 2702(b), then the value of the taxable gift made by the grantor on funding a GRAT is calculated by subtracting the value of the annuity (as determined using the discount rate in effect under Section 7520) from the total value of the property transferred. See Regs. 25.2511-1(e) and 25.2702-1(b). To the extent that the GRAT property earns returns greater than necessary to pay the annuity amounts to the grantor, wealth above the amount of any taxable gift made by the grantor when the GRAT was created passes to the remainder beneficiaries free of additional gift or estate tax, provided that the grantor survives the fixed term. If the remainder is not payable to or for the benefit of members of the grantor's family, then the value of the taxable gift is calculated in the same fashion (i.e., by subtracting the value of the grantor's retained interest from the total value of the transferred property), even if the grantor's retained interest is not a qualified interest, so long as the grantor's retained interest is susceptible of measurement. See Reg. 25.2511-1(e).

2

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 increased the lifetime gift tax exemption amount from \$1 million to \$5 million. The increased amount "sunset" after 2012. The temporary five-fold increase has shifted the focus of estate tax planning from avoiding taxable gifts to

deliberately making them to take advantage of the increased gift tax exemption. Nonetheless, GRATs will no doubt continue to remain a popular strategy for many clients. See generally Blattmachr, Gans, Zaritsky, and Zeydel, "Estate Planning After the 2010 Tax Relief Act: Big Changes, But Still No Certainty," 114 JTAX 68 (February 2011).

3

If the annuity is payable to the grantor or the grantor's estate, it becomes mathematically possible to reduce the value of the taxable gift to zero or nearly to zero. This technique is approved in Reg. 25.2702-3(c), Examples 5 and 6; see also *Walton*, 115 TC 589 (2000), *acq.* Notice 2003-72, 2003-2 CB 964. See McCaffrey, Plaine, and Schneider, "The Aftermath of *Walton*: The Rehabilitation of the Fixed-Term, Zeroed-Out GRAT," 95 JTAX 325 (December 2001), and "IRS Will Follow Tax Court in *Walton* and Will Revise Regulations Accordingly," 99 JTAX 262 (November 2003). It is unclear whether the IRS will respect a GRAT whose remainder has for gift tax purposes a value of zero. See, e.g., TAM 200245053 ("[The Regulations] should not be viewed as sanctioning the utilization of the formula to 'zero-out' a gift") (under Section 6110(k)(3), neither a letter ruling nor a technical advice memorandum may be cited or used as precedent); *cf.* Section 2701(a)(4) (providing that certain junior equity interests in an entity may be valued at no less than 10% of the total equity interests).

4

Reg. 25.2702-3(b)(2) allows the grantor's retained annuity interest to be stated in terms of "a percentage of the initial fair market value of the trust property," provided that the governing instrument contains certain provisions, including that the trust pay to the grantor "within a reasonable period after the final determination of such value" the difference between the amount actually paid to the grantor and the amount that should have been paid, if the initial value had not been understated. See Reg. 1.664-2(a)(1)(iii). In other words, if the property transferred to a GRAT turns out to have been undervalued, the GRAT may be structured so that the grantor's annuity payments will be automatically increased so as to absorb nearly all of the increase in the size of the gift.

5

Despite the gift and estate tax advantages of making lifetime gifts, taxpayers are often reluctant to part with wealth during their lifetimes. With a "zeroed out" GRAT (i.e., one that is structured so the value of the remainder is zero), however, the grantor only gives away returns above the Section 7520 rate. Even if those

returns may be substantial, some taxpayers find it psychologically easier to part with future returns than with realized wealth.

6

If property given to a zeroed-out GRAT fails to earn returns in excess of the Section 7520 rate, the property simply returns to the grantor in the form of annuity payments. If the grantor dies during the fixed term, the property is paid over to his or her estate and all or a portion of it will be included in the gross estate. See Reg. 20.2036-1(c)(2).

7

As discussed in Blattmachr, Slade, and Zeydel, 836-2nd T.M. (BNA), *Partial Interests-GRATs, GRUTs, QPRTs (Section 2702)*, page A-99, the proposition that a program of "rolling" GRATs always succeeds in the long run in passing on wealth to the next generation free of gift and estate tax (so long as the grantor survives) can be demonstrated using Monte Carlo simulations.

8

See, respectively, Treasury Department, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals* ("Green Book") (February 2011), page 128; H.R. 4849, 111th Cong. (2010) (the Small Business and Infrastructure Jobs Tax Act of 2010), section 307.

9

Section 2601(a). In general, a generation-skipping transfer is a gratuitous transfer (whether directly or in trust) to persons, such as grandchildren or more remote descendants, who are deemed to be two or more generations removed from the transferor.

10

Under Section 2631, every individual is allowed a GST exemption amount (currently, \$5 million), which may be allocated to any property of which such individual is the transferor. An allocation of GST exemption effectively reduces the rate of tax imposed on a generation-skipping transfer, often to as little as zero.

11

The discussion in this section assumes that, as argued later in this article, it is in fact possible to allocate GST exemption to a GRAT as of the date of funding.

12

Section 2641(a).

13

Section 2642(a)(1).

14

A direct skip is a transfer of an interest in property to a "skip person," such as a grandchild or more remote descendant; see Section 2612(c).

15

Section 2642(a)(2). The denominator is reduced by (1) the amount of federal estate tax or state death tax actually recovered from the trust and (2) any charitable deduction allowed with respect to the transferred property.

16

A trust is a "skip person" only if all "interests" in the trust are held by skip persons, or, if there is no person holding an interest in such trust, at no time after the transfer to the trust may a distribution be made from such trust to a non-skip person. See Section 2613(a)(2).

17

See note 15, *supra*.

18

Section 2612(c).

19

These conditions are merely sufficient conditions for the trust applicable fraction to apply. The trust applicable fraction may in some cases apply if these conditions are not satisfied.

20

Section 2652(a)(1); Reg. 26.2652-1(a)(1).

21

Reg. 26.2652-1(a)(1).

22

Reg. 26.2652-1(a)(2).

23

If a GRAT is completely zeroed out, such that the transfer to the GRAT is not ever subject to gift tax, then, arguably, no transfer for GST tax purposes will have ever occurred, and the GRAT property (if the grantor survives the fixed term) will never be subject to GST tax. The Service's objections to zeroed-out GRATs are based on policy arguments under Procter, 32 AFTR 750, 142 F2d 824 (CA-4, 1944); see TAM 200245053. A string of recent court decisions has recently rejected such arguments in certain contexts: McCord, 98 AFTR 2d 2006-6147, 461 F3d 614 (CA-5, 2006); Estate of Christiansen, 104 AFTR 2d 2009-7352, 586 F3d 1061 (CA-8, 2009); Estate of Petter, TC Memo 2009-280, RIA TC Memo ¶2009-280 . In light of these cases, Regulations approving annuity adjustments if property transferred to a GRAT is undervalued, and Regulations making it mathematically possible to zero out a GRAT, it may now be possible to create perpetually GST-exempt GRATs without allocation of GST exemption.

24

Section 2652(b)(1); Reg. 26.2652-1(b)(1).

25

Restatement (Second) of Trusts, section 2.

26

Reg. 301.7704-4(a) states that "the term 'trust' as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts." A full discussion of this definition is beyond the scope of this article. In the author's view, the definition is anachronistic and should not be construed literally. *Cf. De Bonchamps*, 5 AFTR 2d 1323, 278 F2d 127 (CA-9, 1960) (characterizing the prior regulatory definition of "trust" as an "aid[] in the determination of whether a taxable entity should be taxed as a trust or as a corporation," which must be construed in a fashion that makes the definition "meaningful and purposeful in a tax context"). For example, under the widely adopted Uniform Prudent Investor Act, the "purpose" of a trust is not in general to "protect" or "conserve" specific property but rather to manage a portfolio of assets for total return.

27

Reg. 301.7704-4(b). It ought not to make a difference for GST tax purposes whether a business trust is a "trust." An individual who contributes property to a business trust typically does so free of donative intent and in the ordinary course of business. Thus, neither gift nor GST tax should apply. See Reg. 25.2512-8.

28

Reg. 26.2652-1(b)(1).

29

It also is possible for the grantor's retained interest to be for the life of the grantor; see Reg. 25.2702-3(d)(4). In that event, all or a portion of the property would be included in the grantor's gross estate. See Regs. 20.2036-1(c)(1) and (c)(2)(iii), Example 4.

30

See Regs. 25.2511-1(e) and 25.2702-1(b).

31

Sections 2654(b)(1) and (2); Reg. 26.2654-1. It also is possible in some instances to "sever" a single trust into two or more new separate trusts. See Regs. 26.2654-1(b) and 26.2642-6.

32

Reg. 26.2654-1(a)(1)(i). There is an exception if separate trusts are required to be created from a single trust at a future date. In that event, the separate trusts may be treated as separate trusts for GST tax purposes after the date of the division. See Reg. 26.2654-1(a)(1)(iii).

33

The concept of "separate and independent shares" derives from Section 663(c), an income tax provision that affects the income tax attributes of separate shares of a trust during a given tax year; see Reg. 26.2654-1(a)(1)(i). As an income tax concept designed to allocate annual income tax liability, it does not by its nature apply to successive interests in a single trust. For instance, in Reg. 1.663(c)-5, Example 11, income during a period of estate administration was payable to charity and the residue was payable in equal shares to the decedent's three children. This dispositive scheme does not, according to the Regulation, result in one "share" for charity and another "share" for the three children, but rather three separate shares, each consisting of an income interest for charity and a remainder interest for one of the children.

34

Nevertheless, the Regulations do not always adhere to the ordinary meaning of "transfer." For example, if QTIP property is included in a surviving spouse's gross estate under Section 2044, the survivor will be treated as the transferor, even though he or she did nothing to fund the trust or dispose of its property; see Reg. 26.2652-1(a)(1). Similarly, it appears that a "transfer" for GST tax purposes may occur if a taxpayer declares an irrevocable trust of property that he or she never in fact transfers.

35

Section 2652(c)(1) defines the meaning of an "interest in property held in trust." If a transfer is made to a trust in which a non-skip person has an interest, then the transfer is not subject to GST tax. The property may be subject to GST tax, however, if there is a taxable distribution or taxable termination; see Sections 2611 and 2612.

36

A trust generally is a skip person only if all interests are held by skip persons; see Section 2613(a)(2)(A). If a trust is not a skip person, then the transfer to the trust is not a direct skip; see Section 2612(c)(1). As the other types of generation-skipping transfers involve terminations of interests in trusts or distributions from trusts, the transfer to the trust in this example is not subject to GST tax, as it is not a direct skip transfer.

37

Section 2612(a)(1).

38

A similar distinction between "property" and the interests in property also is found in the marital deduction Regulations; see Reg. 25.2523(b)-1(a)(3) ("[A] distinction is to be drawn between 'property,' as such term is used in section 2523, and an 'interest in property.' The 'property' referred to is the underlying property in which various interests exist; each such interest is not, for this purpose, to be considered as 'property'").

39

In keeping with the notion that the GST tax applies to "property" and not to successive interests in property, Reg. 26.2652-1(b)(1) includes in the definition of "trust" any arrangement involving successive interests.

40

Section 2613(a)(2)(A); Reg. 26.2612-1(d)(2). Special definitions apply to a trust in which no person has a current interest.

41

Section 2653.

42

After the expiration of the fixed term, distributions to or for the benefit of skip persons-in our example, the

grandchildren of the grantor-will be subject to GST tax as taxable terminations or taxable distributions. See Sections 2611 and 2612.

43

If a grandchild's parent who is a child of the transferor is deceased at the time of the transfer, the grandchild is treated as a child of the transferor and is therefore not a skip person; see Section 2651(e).

44

Regs. 26.2632-1(b)(4)(i) and 26.2632-1(d)(2), permitting formula allocations of GST exemption-for example, an allocation of "an amount of GST exemption necessary to reduce the inclusion ratio to zero"-are not the taxpayer's friend in the case of a GRAT. A taxpayer who makes a formula allocation to a GRAT may end up wasting more GST exemption than if the taxpayer had only allocated a specific dollar amount.

45

A CLAT is a trust in which one or more charities have a right to an annuity for a term of years or for the lives of one or more individuals. On expiration of the charitable annuity interest, the remainder is typically payable to or for the benefit of members of the grantor's family.

46

Section 2642(a)(2)(B)(ii)(II). Legislative history confirms that the purpose of Section 2642(e), which was enacted as part of TAMRA (P.L. 100-647, 11/10/88), was to prevent taxpayers from "deducting the present value of any charitable lead annuity interest from the denominator of the applicable fraction," so as to "leverag[e] the exemption amount." S. Rep't No. 100-445, 100th Cong., 2d Sess. 368 (1988).

47

The results of allocating GST exemption to GRATs are less favorable than the results of allocating GST exemption to CLATs.

48

Section 2612(a)(1).

49

Section 2622.

50

Section 2642(e)(2).

51

The author believes that the heretofore-undisclosed purpose of Example 4 is to prevent the creation of a new transferor when a disposition is made under Section 2519 of a qualifying income interest for life in a reverse QTIP trust.

52

Reg. 26.2632-1(c)(2)(i).

53

Indeed, the Regulations' examples of transfers subject to an ETIP all involve retained lead interests or else do not specify the source of the ETIP. Reg. 26.2632-1(c)(5), Examples 1-5.

54

Reg. 25.2523(a)-1(e).

55

Section 2652(c)(1).

56

Reg. 20.2041-1(b)(2).

57

Reg. 25.2503-3(b).

58

Section 2652(c)(1).

59

Regs. 20.2041-1(b)(2) and 20.2041-3(f), Example 4. The grantor's reversionary interest also may be includable under Sections 2036(a)(1) or 2037.

60

Estate of Alexander, 81 TC 757 (1983). By contrast, a retained power to affect timing does not prevent a completed gift; see Reg. 25.2011-2(d).

61

Reg. 26.2632-1(c)(5), Example 2.

62

See, e.g., Schwager, 64 TC 781 (1975) (proceeds of employer-owned life insurance were included in the insured-decedent's gross estate merely because the decedent's consent was required for the employer to change the beneficiary designation).

63

Reg. 26.2632-1(c)(1). For example, if a grantor creates a trust of \$1 million, retains the right to income for nine years and allocates \$100,000 of GST exemption to the trust, the allocation will not be effective until the earlier of nine years or the grantor's death. If at that time the trust has a value of \$2 million, the inclusion ratio will be  $1 - (\$100,000/\$2,000,000)$ , or 0.95. See also Reg. 26.2632-1(c)(5), Examples 1 and 2.

64

These tables are revised decennially by Treasury pursuant to Section 7520. Tables with a mortality

component may not be used to determine the value of an interest measured by the life of a terminally ill individual; see Reg. 20.7520-3(b)(3).

65

See *Mayo Foundation for Medical Education and Research*, 107 AFTR 2d 2011-341, 178 L Ed 2d 588 (2011), amplifying *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 US 837, 81 L Ed 2d 694 (1984). The level of deference due the 5% probability rule is outside the scope of this article. For a thorough discussion of the evolving area of judicial deference to tax Regulations, see Gans, Blattmachr, and Rios, *Circular 230 Deskbook* (PLI, 2011), Chapter 1. See also Lipton and Young, "*Mayo Foundation*, Treasury Regulations, and the 'Death' of *National Muffler*," 114 JTAX 206 (April 2011).

66

Regs. 20.2036-1(c)(1) and (c)(2)(iii), Example 4.

67

*Morgan v. Keyes*, 198 Misc 984, 99 NYS2d 820 (Sup. Ct., 1950), *aff'd* 278 App. Div. 653, 101 N.Y.S. 2d 939 (1st Dept., 1950), *aff'd on other grounds* 99 NE2d 230 (Ct. App., 1951).

68

The value of a decedent's remainder interest in any property is includable in the gross estate under Section 2033, if it is payable to the decedent's estate and is not extinguished at death. See Regs. 20.2041-1(b)(2) and 20.2041-3(f), Example 4. A retained right to income from property transferred by a decedent that takes effect only after the death of another beneficiary is includable in the decedent's gross estate under Section 2036(a)(1). See Reg. 20.2036-1(b)(1)(ii); but see *Wyly's Estate*, 45 AFTR 2d 80-1737, 610 F2d 1282 (CA-5, 1980) (holding that interests "created by operation of law" are not "retained" within the meaning of Section 2036(a)).

69

*Estate of Alexander*, *supra* note 60. A retained power to affect timing does not, by contrast, prevent a completed gift; see Reg. 25.2011-2(d).

70

To do so, as discussed in the text, below, taxpayers may have to elect out of the automatic allocation rules of Section 2632(c).

71

Sections 2632(c)(1) and (c)(3)(A).

72

If more than 25% of the corpus of the GRAT must be distributed or may be withdrawn by individuals (such as by the grantor via the annuity interest, or by the grantor's children) who are not skip persons before such individuals attain age 46, then the GRAT is exempt from the automatic allocation rules; see Section 2632(c)(3)(B)(i). Other exceptions to the automatic allocation rules also may apply under Section 2632(c)(3)(B).

73

Reg. 26.2632-1(b)(2)(iii)(C)(2). The grantor also may prevent application of the automatic allocation rules by making an affirmative allocation of GST exemption; see Reg. 26.2632-1(b)(2)(ii). As discussed, however, GST exemption should not be allocated to a GRAT.

74

A provision neutralizing automatic allocation of GST exemption should perhaps be considered not only in GRATs but in every trust that is not designed to have GST exemption allocated to it, such as personal residence trusts or many life insurance trusts.

75

See Sections 2041(b)(2) and 2514(e).

76

Reg. 26.2642-4(a)(4).

It may be possible for the estate to trace the source of the funds paid to the estate from the GRAT, so that the estate can prove that such funds ultimately end up (for example) in trusts for descendants created under the grantor's will. It is not clear, however, whether the IRS will respect this tracing. Absent a specific provision in the grantor's will disposing of such funds, the funds could be used to satisfy any liabilities of the estate. Thus, the Service may argue that a pro rata portion of the partially or fully GST-exempt funds must be deemed to have been used to pay administration expenses, claims, and all other bequests under the will.

It might be argued that a bequest of an annuity interest in a GRAT causes a portion of the retained interest to fail to meet the requirements of Reg. 25.2702-3(e), Examples 5 and 6, which require that post-death annuity payments be made to the grantor's estate (as opposed, perhaps, to a legatee under the grantor's will) in order to be treated as qualified interests. Most likely this argument would not be raised unless the grantor dies during the fixed term and actually makes a bequest of the annuity interest. As a practical matter, the argument, even if successful, may not result (depending on interest and penalties) in any additional gift and estate taxes. First, if the decedent is treated as having made a larger taxable gift than anticipated, the decedent's estate would receive the equivalent of a credit under Section 2001(b)(2) for any gift taxes paid on the gift. Indeed, if the GRAT was created more than three years prior to death, the estate might even prefer the annuity payments to have been nonqualified, as any gift taxes paid on the gift would then escape gross estate inclusion under Section 2035(b). Finally, while the decedent might be deemed to have used up lifetime gift tax credit before death, the "unified credit" would in effect be restored at death, as the increased taxable gift would not be included in the computation of estate tax as an "adjusted taxable gift" under Section 2001(b). Thus, at least in the author's view, there is not a significant downside to making a bequest of an annuity interest in a GRAT.

Reg. 26.2642-4(a)(4) provides that the applicable fraction immediately before death will not change. Therefore, even though the GRAT property is included in the grantor's gross estate, which may give rise to a new "transferor" of the GRAT property (albeit, the same individual who created the GRAT in the first place), there should be no need to allocate additional GST exemption to the GRAT to keep it partially or fully

GST-exempt.

80

*Cf.* Reg. 26.2651-1(a)(5), Example 4 (holding that a gift of an income interest in a trust does not cause a change in transferors for GST tax purposes, even though the gift is subject to gift tax).

81

Arguably, a failure to exonerate any GRAT from the payment of its share of estate taxes creates a nonqualified interest that will prevent zeroing out.

82

See, e.g., N.Y.E.P.T.L. sections 2-1.8(d)(3) and (e). See also Section 2207B.

83

Reg. 26.2642-4(a)(1).