

## Drafting Tips for Zeroed-Out GRATs

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Zeroed out GRATs are currently an extremely attractive planning strategy for a number of reasons. First, the *Walton* opinion has finally eliminated the debate among planners as to whether a GRAT can be zeroed out. Second, while the Applicable Credit for estate tax purposes has been increased, the Applicable Credit for gift tax purposes is now subject to a ceiling, limiting tax-free gifts to \$1,000,000. This ceiling makes the latter extremely valuable to clients so that strategies that operate to preserve it are very appealing. Third, the object with almost any “successful” GRAT is to fund it with assets that appreciate more than the 7520 rate. With interest rates currently so low, that is a near certainty. Finally, now as always, the GRAT is a statutory creature, unlike the rival strategy – the sale to a defective grantor trust. Because the GRAT is statutory, it is not beset with the open issues that have always made certain planners nervous where the sale to defective trust is concerned, such as whether the note is includable in the grantor’s estate if he or she dies before it is paid off.

1. Fit the Annuity Squarely Within the Walton Decision. *Walton*, 155 T.C. 589 (2000), is the only authority for zeroing out a GRAT, and the IRS has now acquiesced in the decision (Notice 2003-72). The annuity must be for a term of years, payable to the Grantor, or if the Grantor is not living, to the Grantor’s estate.
2. A Revocable Contingent Annuity Interest for Spouse is No Longer Necessary. The *Schott*, 319 F.3d 1203 (9<sup>th</sup> Cir. 2003), *rev. and rem.* 80 TCM 1600 (2001), and *Cook*, 269 F.3d 854 (7<sup>th</sup> Cir. 2001), *aff’g* 115 T.C. 15 (2000), cases deal with the attempt to reduce gift tax exposure by giving the surviving spouse a contingent annuity interest. After *Walton* and Notice 2003-72, this technique is no longer necessary because the GRAT can be zeroed out.

3. Pay the Annual Annuity on the Anniversary Date of the Agreement. Using a 12-month period ending on the anniversary date of the agreement keeps the assets in the GRAT as long as possible, allowing them to grow. This is permitted by Treas. Reg. §25.2702-3(b)(3). Do not use the calendar year, unless the trust agreement was executed on December 31. Using the calendar year means there will be one extra payment for the stub year.
4. Take Advantage of the Formula Annuity Allowed by the Regulations. Defined value formula clauses are under attack by the IRS, but in a GRAT such a formula clause is allowed by the Regulations. Reg. §25.2702-3(b)(ii) provides that the annuity amount may be stated as a fixed percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes. Thus, a subsequent determination that the property was undervalued will simply work to increase the value of the annuity and should not significantly increase the value of the taxable gift.
5. Allow for Late Annuity Payments. Treas. Reg. 25.2702-3(b)(4) allows the annuity to be paid within 105 days after the anniversary date. Although the regulation seems to allow such a payment even if the provision is not in the trust agreement, including such a provision in the trust agreement is a useful reminder of this rule and may facilitate some planning opportunities with respect to the annuity payment.
6. Don't Forget to Protect the Marital Deduction if the Grantor Dies During the GRAT Term. If the Grantor dies during the GRAT term leaving a surviving spouse, the remainder interest can be directed away from descendants into a marital trust to defer the payment of estate tax until the death of the surviving spouse. There is some concern among commentators that if the remaining annuity payments, as directed by the Grantor's Will, and the remainder end up passing to the spouse outright or to the same marital trust, the IRS would argue that these "merged" interests are really a reversionary interest, so that no value would be given to the post-death payments and the GRAT could not be zeroed out. In order to avoid this potential argument, two possible solutions are: (1) create a separate contingent QTIP within the GRAT itself and (ii) give the Grantor a power of appointment over the remainder interest if he or she dies during the trust term.

Also, the marital deduction for the remaining annuity payments should be preserved by providing that the GRAT will pay to the Grantor's estate the greater of net income and the annuity amount.

7. Structure the Trust as a Grantor Trust. The GRAT should be a grantor trust, at least during the retained annuity period, so that if the annuity payments are made in kind, there is no taxable event for income tax purposes. In addition, the tax on any gains taken by the GRAT will be paid by the grantor, not the GRAT, thereby keeping more assets in the trust to pass down to the next generation. To achieve

grantor trust status, the grantor is typically given a non-fiduciary power to reacquire trust assets from the GRAT by substituting property of equal value, see IRC Sec. 675(4), or another administrative power under Section 675. Alternatively, the grantor could retain the right to receive the greater of the trust income and the annuity amount, plus a general testamentary power of appointment.

8. Watch Out for Skip Beneficiaries. Because of the ETIP rules, GST exemption cannot be applied to the GRAT until the end of the term of years. If the Grantor survives the trust term, make sure GST planning is done with respect to potential distributions to skip persons.