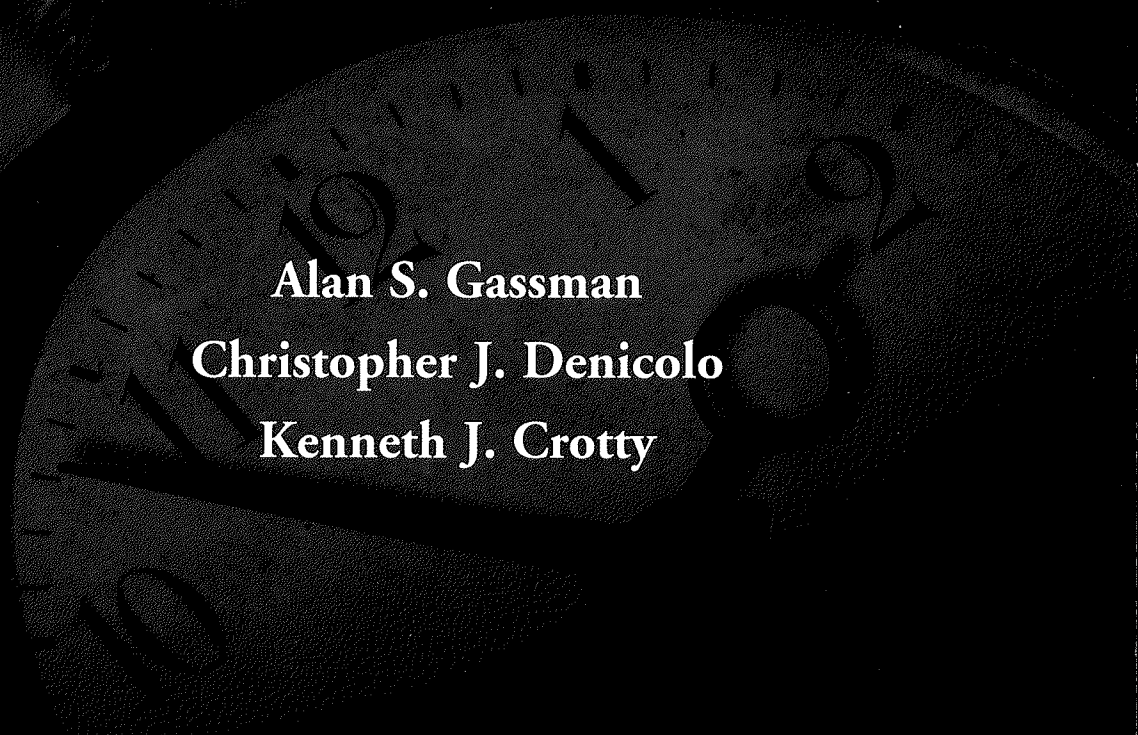
Estate Tax Planning in 2011 and 2012



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GRATS ARE STILL GREAT!

Introduction

The federal estate tax is here to stay. The very possibility of a decreased estate tax exclusion of $1,000,000 per person in 2013 demonstrates that the government is currently looking to earn more revenue through the estate tax, and shows just how permanent this tax is going to be.

Although many taxpayers will potentially be subject to the federal estate tax in coming years, their estates may never become taxable by reason of dynamic planning strategies which permit diversion of value to trusts outside of the taxpayer's "taxable estate." These strategies can provide significant family benefits during the lifetime of a wealthy taxpayer, and are not as complicated or convoluted as may at first seem.

Of these strategies, the Grantor Retained Annuity Trust (GRAT) is probably the most potent, yet least understood, vehicle.

Big Picture

Congress' primary goal in enacting GRAT legislation in 1990 was to permit a Grantor to place assets into a trust and receive back a specified amount in value over a term of years. The assets held under the GRAT could grow in value and/or generate income that would remain under the GRAT, to be held on an estate-tax-free basis after the GRAT term. Actuarially, the GRAT mechanism allows growth and income above an interest rate that is prescribed by the IRS (which is tied to the Treasury Bond Index level) to pass estate-tax-free.

Example 1

A Grantor might place $1,000,000 of cash or investments into a GRAT that would be held for the Grantor's spouse and children.

The GRAT would be required to pay the Grantor $200,000 per year in cash or other assets for five years.

Anything left in the GRAT after the fifth annual payment could be held for the lifetime benefit of the Grantor's spouse or descendants without being subject to federal estate tax at the level of the Grantor or his or her spouse.

If $1,000,000 in equity stocks were placed in the GRAT, and the stocks grow at 7% per year, then after the fifth year of paying the Grantor $200,000 per year, there would be $252,404 worth of stock in the GRAT that would never be subject to estate tax upon the death of the Grantor, or upon the death of the Grantor's spouse.

"Zeroed-Out" GRATs and Formula Clauses – Unique Features That Increase the Attractiveness of GRATs

When a GRAT is funded, an actuarial calculation is performed by a software program which determines how much of a gift (if any) is considered to have been made upon funding of the GRAT. In Example 1 above, based upon the applicable federal rate in effect for November 2010 (2.0%), the gift element of a $1,000,000 transfer to a GRAT, with a $200,000 per year repayment for five years is only $57,300. If we use the 2011 - 2012 lifetime gifting exclusion level of $5,000,000 per person, this leaves $4,942,700 remaining that the Grantor is able to gift over his or her lifetime estate-tax-free.

If the payments for the GRAT discussed in Example 1 above were $212,156.57 per year for the five years, then the gift element would be considered to be $0, and no gift tax return would have to be filed when the GRAT is established. This is called a "zeroed-out GRAT."

When GRAT legislation first appeared in 1990, many academicians believed that it was not safe to attempt a zeroed-out GRAT. However, based upon case law and analysis that has occurred since then, most published authorities agree that zeroed-out GRATs are considered to be safe from a tax-compliant standpoint.

Another excellent feature of a GRAT relates to the ability to use a "formula valuation clause" in the GRAT document. In the example above, the GRAT document would not necessarily provide that the Grantor would receive exactly $200,000 in cash or other assets per year for five years. Instead, the GRAT document would provide that the Grantor would receive 20% of the initial contribution value of the GRAT per year, in five annual installments.

This feature allows the GRAT to be especially favorable with assets that are "hard to value" or assets that do not have a clearly defined value. The reason for this is that it absolutely prevents the IRS from imposing a gift tax in a situation where assets placed in the GRAT may be considered to be worth much less than what the IRS eventually determines as an appropriate value.

For example, assume that someone wants to put 1/3 ownership of a closely-held company into a GRAT, and values the stock at $1,000,000. If the IRS later determines that the stock was worth $2,000,000, then no gift tax will be due. Instead, by the terms of the GRAT document and applicable legislation, the annual payments will be redetermined to have been $400,000 per year (20% per year of the value of the assets at contribution for five years), and the Grantor will receive more cash and other assets from the GRAT, but the IRS will not be owed any gift tax.

This significantly reduces the motivation of a gift tax auditor to challenge the values of assets that are contributed to a GRAT.

The combination of the above techniques and valuation discounts makes the GRAT a very exceptional and often successful wealth transfer vehicle for closely-held businesses and/or investment income arrangements.

Example 2

Assume, for example, that a business owned by a family LLC generates $1,000,000 a year of income and is considered to be worth $5,000,000.

Thirty percent of the stock of the company would be worth $1,500,000 before discounts, but might be valued at $1,050,000, assuming a 30% valuation discount applicable to a minority interest in the company.

For a five-year GRAT established in November 2010, 30% of the stock of the company would be transferred into the GRAT in exchange for the right to receive annual payments of $222,765 per year for five years. Each payment represents 21.22% of the initial contribution amount of $1,050,000. ($222,765 ÷ $1,050,000 = 21.22%).

Assuming that the company pays dividends of $1,000,000 per year, the GRAT would receive $300,000 per year and would pay the Grantor $222,765 per year as the annual GRAT payment.

The GRAT would be able to invest $77,235 per year in an investment account or however else it determines appropriate. ($300,000 - $222,765 = $77,235)

After the fifth year, the GRAT would have accumulated $386,175 ($77,235 x 5), plus whatever earnings it might receive under the investment account, and would continue to own 30% of the stock of the company, at a zero gift tax cost!

Example 3

To use another example, assume that an LLC owns rental property worth $10,000,000, and has net positive cash flow of $800,000 per year.

A 10% ownership interest in the LLC may be worth $700,000, after applying a 30% valuation discount ($10,000,000 x 10% = $1,000,000; $1,000,000 x 70% = $700,000), and would be expected to receive $80,000 a year of rent income.

If a five-year GRAT were used, then 21.22% of $700,000 is $148,510, so the rental income on the 10% interest is not sufficient to make the GRAT payments alone.

The client might instead choose to use a 10-year GRAT. A 10-year zeroed-out GRAT would require payments of approximately 11.13% per year, which would result in an annual payment back to the Grantor of $77,929.

In this example, the GRAT would receive $80,000 a year in distributions from the LLC and make $77,929 per year in annual payments to the

Grantor, which leaves $2,071 per year of excess rental income in the GRAT.

If the GRAT does not have sufficient cash flow to make the annual required payments then the GRAT payments can be made in cash or "in kind" by having the GRAT distribute property outright to the Grantor.

Therefore, part ownership of an LLC or other investment can be transferred back to the Grantor to satisfy a GRAT payment.

Example 4

For example, assume in the case of the operating company described in Example 2 above that the company chose to reinvest its earnings in the fourth and fifth years instead of paying dividends, and that the stock of the company owned by the GRAT was worth $2,250,000 during the fourth and fifth years.

The $222,765 annual GRAT payment divided by $2,250,000 is 9.9%. Because the GRAT owned 30% of the company, it would simply transfer 9.9% ownership of the company back to the Grantor in year four and 9.9% ownership of the company in year five.

As a result, the GRAT would still own 10.2% of the company after the fifth year, plus whatever it had saved from positive cash flow, and the earnings and appreciation thereon. Hopefully the company would have an increased value in the future based upon its reinvested earnings.

What if the GRAT underperforms?

What happens if the GRAT underperforms expectations, and asset values and/or income is not sufficient to allow all of the GRAT payments to be made?

As discussed above, the GRAT is able to use its assets to make the required annual GRAT payments, and the GRAT may use all of its assets to make the payments, if necessary.

Once the GRAT runs out of assets, there is nothing further that needs to be done. If the initial gift element of the GRAT is considered to be very small, then there is "nothing lost" by having tried to use the GRAT structure.

For example, assume that under the real estate structure described above in Example 3, the tenant of the real estate properties goes out of business and the company cannot find another tenant. As a result, the company does not have the rental income that was previously anticipated.

Ownership interests in the company could be transferred back to the Grantor each year to satisfy the annual GRAT payments. If the company has gone down in value, then the Grantor may receive all ownership and monies back from the GRAT, but nothing has been lost in the process.

How do GRATS work for income tax purposes? Very well!

Although the GRAT is completely separate and apart for estate and gift tax purposes, for income tax purposes the GRAT can be "disregarded," and all of the income that the GRAT earns can be recorded and paid for under the Grantor's Form 1040 income tax return. This allows the GRAT to grow income tax-free, and to be indirectly subsidized by the Grantor. The taxes that are to be paid by the Grantor can be taken into account in determining what percentage of a given entity or what amount of various investments will be transferred to the GRAT by the Grantor.

For example, a Grantor may initially think that it is best to transfer a 20% interest in a company to the GRAT, but might decide that 15% interest in the Company is best, after taking into account that the Grantor will pay the income tax on the GRAT's income.

Once the payments to the GRAT have expired (five years in Example 2 above, and 10 years in Example 3 above), the GRAT can pay its own taxes, or may be designed to permit the Grantor to pay its taxes until the Grantor decides otherwise!

What happens if the Grantor dies before receiving all the annual payments?

If the Grantor dies before receiving all GRAT payments, then all of the GRAT assets will be considered to be owned by the Grantor, and therefore, will be includable in the Grantor's estate for federal estate tax purposes.

However, by drafting appropriate provisions into the GRAT and into the Grantor's will, any GRAT assets that are included in the Grantor's estate for federal estate tax purposes can be passed to the surviving spouse, or into trust for the surviving spouse, to qualify for the estate tax marital deduction. The result of such action is that no estate tax will be incurred with respect to the inclusion of the GRAT assets in the Grantor's estate for federal estate tax purposes.

Do you have to have ownership in a closely held business or in income-producing real estate to use a GRAT?

Many GRATs are used by clients who simply have equities portfolios, vacant real estate, or other passive investments.

A common example would be a two-year, zeroed-out GRAT (the shortest GRAT term available) funded with the stock of a company or a mutual fund. A client places $1,000,000 worth of stock into the GRAT, and will receive $515,040 on the first anniversary of the GRAT and $515,040 on the second anniversary of the GRAT.

If the stock is worth $1,200,000 at the end of the first year, then the GRAT still has $684,960 remaining after the first annual payment.

If the stock is worth $750,000 at the end of the second year, then the Grantor receives $515,040 worth of stock or funds, and the GRAT thereafter holds $234,960 of assets that will pass estate tax free.

Is it best to use a long-term or short-term GRAT?

The conventional wisdom has been to use as short of a GRAT term as can work well under a given scenario, for two primary reasons:

1. If the Grantor dies during the GRAT term, the assets held in the GRAT are going to be subject to federal estate tax. A short term lessens the possibility of death during the term. However, as addressed above, it is possible to pass the assets to the surviving spouse in such a way to avoid incurring federal estate tax.
2. If the assets under the GRAT go up in value, and later go down in value, then the family would have been better off if the GRAT had ended before the value decline. This also argues for a short-term GRAT.

What "technical rules" should I know with respect to establishing a GRAT?

As with all irrevocable trusts, a GRAT should be drafted and implemented with the assistance of a competent tax and estate planning lawyer. Most lawyers who work extensively with GRATs have post-law graduate degrees in taxation or estate planning (an LL.M. degree), or board certification as a tax or trusts and estates lawyer. Other lawyers who are not as well-versed in tax law or estate planning will sometimes obtain assistance from a tax lawyer. It is not safe to just "use a form from last year" or to use one GRAT form for all situations.

The GRAT needs to be irrevocable and needs to be funded upon the day that it becomes irrevocable. The law does not permit additional contributions to be made to a GRAT after it is executed.

Some lawyers use special clauses that permit the GRAT to remain revocable until it has become fully funded. Documents can also provide that inadvertent later transfers to the GRAT, as well as forgotten payments, can be considered as set aside under a separate non-GRAT subtrust so that the GRAT continues to comply with the tax law requirements.

The GRAT document can provide that the Trustee make the scheduled payments for the benefit of the Grantor, which may be appropriate if the Grantor has creditor issues or competency issues in the years after the GRAT is established.

Some GRATs are established in offshore jurisdictions in order to help assure that future creditors of the Grantor would not be able to access GRAT payments. Some states, such as Florida and Texas, have statutes which protect annuity contract rights from creditors. It is widely believed

that GRAT payments can qualify as a creditor-protected annuity asset if properly drafted.

Many sophisticated lawyers draft a "two-trust GRAT system," consisting of the GRAT trust as described above and a separate "GRAT Remainder Trust" which is funded with all remaining assets that remain in the GRAT after the last scheduled GRAT payment. Having the "remainder interest" held by a separate trust makes it possible for the family to "purchase the remainder interest" if and when the circumstances would make this favorable from an estate tax avoidance standpoint.

Of course, a proper formula clause is also essential. As discussed above, GRATs should provide that annual payments are based upon a percentage of the initial contribution value rather than upon specified dollar amounts.

The GRAT document will also determine whether the GRAT or the GRAT remainder trust will be taxed as a separate entity for income taxes after the GRAT payment term, as opposed to being considered as owned by the Grantor and thus "disregarded" for income tax purposes, as described above under the heading entitled "How do GRATS work for income tax purposes? Very well!"

Do the annual payments have to be equal each year?

It would make sense to delay payments as long as possible so that the GRAT can grow a larger amount of assets than it would if it had to make required payments The increased value of assets held under the GRAT could lead to greater appreciation and income earned by the GRAT with respect to such assets.

The law does permit the payments to start smaller and increase by no greater than 20% per year. Based upon a $1,000,000 contribution, and a five-year, zeroed-out GRAT with payments that increase by 20% per year, the annual payments could be as follows:

Year 1:	$143,568	14.3568%
Year 2:	$172,283	17.2283%
Year 3:	$206,739	20.6739%
Year 4:	$248,087	24.8087%
Year 5:	$297,704	29.7704%

As you can see from the above, the GRAT payment for each of the years 2 through year 5 are 20% greater than the payment made in the previous year.

On a 10-year, zeroed-out GRAT that is based on the same assumptions as the previous example, the numbers would be as follows:

Year 1:	$44,124	4.4124%
Year 2:	$52,949	5.2949%
Year 3:	$63,539	6.3539%
Year 4:	$76,247	7.6247%

Year 5:	$91,496	9.1496%
Year 6:	$109,795	10.9795%
Year 7:	$131,754	13.1754%
Year 8:	$158,105	15.8105%
Year 9:	$189,726	18.9726%
Year 10:	$227,671	22.7671%

The applicable tax law regarding GRAT payments permit a GRAT payment to be delayed for up to 105 days after the anniversary date of the funding of the GRAT. For example, if a GRAT was established and funded on July 1, 2010, the first annual GRAT payment can be made at any time before October 14, 2011. Likewise, the second annual GRAT payment can be made at any time before October 14, 2012.

Once the Grantor receives payments back, the assets that the Grantor has received are "unfrozen" and therefore would be included in the Grantor's gross estate for federal estate tax purposes upon the Grantor's death, even if the Grantor survives the GRAT term. However, the GRAT payments that are received by the Grantor can be used for the payment of living expenses for the Grantor and his or her spouse, which would reduce the Grantor's taxable estate.

What happens with respect to income tax reporting and payment if I set up a GRAT?

One very nice feature of a GRAT is that it can be "disregarded" for income tax purposes, and therefore does not need to file a full income tax return or pay its own income taxes.

Under the income tax rules, all of the income and deductions of the GRAT can simply go on the Grantor's personal individual or joint tax return. If the GRAT has income then the Grantor, in effect, subsidizes it by paying the income tax attributable to what it earns, and the payment of the GRAT's income taxes by the Grantor is not considered to be a gift under federal tax law.

The annual (or more frequent) payment from the GRAT to the Grantor is also disregarded for income tax purposes, so there is no extra tax or any sort of deduction generated as a result of the GRAT payment mechanism.

After the GRAT stops making annual (or more frequent) payments to the Grantor, then it may be taxed as a separate entity and be responsible for paying its own income taxes. Alternatively, the GRAT may be structured strategically as "disregarded" for income tax purposes, so that the Grantor can continue to subsidize the GRAT by paying the income taxes on the GRAT's earnings.

It is also possible to draft a GRAT such that the Grantor or appointed advisors can determine whether the GRAT would pay its own taxes or be disregarded for income tax purposes after the GRAT payment term has ended. For example, the Grantor would pay income tax on the income

earned by the GRAT during the annual or quarterly payment period, and may decide that it is best to continue to subsidize the GRAT by having it be "disregarded" for income tax purposes for a few years after the last GRAT payment.

If the Grantor, however, has an economic reversal and decides that he or she would like for the GRAT to pay its own income taxes, then that can occur if the GRAT has been designed to "toggle off" its income tax "disregarded entity" status. In that event the GRAT would be subject to income tax in its own separate brackets, except that income tax liability will generally be carried out with monies that are distributed to GRAT beneficiaries under the "complex trust" income tax rules, and the beneficiaries would essentially pay the tax associated with the GRATs income.

Estate Tax Planning in 2011 and 2012

This desk reference is an essential tool for estate planners wishing to take advantage of the tax planning opportunities available in 2011 and 2012 following the enactment of the 2010 Tax Relief Act.

Estate Tax Planning in 2011 and 2012, written by seasoned practitioners, describes the provisions of the new law, including:

- Opportunities to shelter a larger portion of the estate from tax
- Why it makes sense to make gifts now
- Planning for the moderately wealthy client
- Why this is the time to consider a dynasty/asset protection trust
- The continued role of life insurance
- The new portability provision and why it is not a panacea for planners
- Many examples, client letters, trust language, and more

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