

LEGAL ALERT

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ESTATE PLANNING UPDATE CONTINGENCY ESTATE PLANNING: GRANTOR RETAINED ANNUITY TRUSTS

By: George F. Bearup

These are uncertain times. The uncertainty comes from threats of war, terrorism and SARs, but also on the domestic front with regard to tax reform. One never knows when they open the next paper whether they will read if Congress will have announced its intent to repeal the federal estate tax, that it will accelerate that estate tax repeal (President Bush's agenda), or that it will postpone indefinitely estate and gift tax repeal due to current government deficits (Presidential candidate Gephardt). During these uncertain times, it is almost impossible for people to plan.

There are some fairly passive techniques that people can adopt to "hedge their bets" on whether or not federal estate taxes will be repealed. One such the technique is the creation of a Grantor Retained Annuity Trust (GRAT) to which assets are transferred. A GRAT is a Trust that holds property in which the Grantor retains an interest for a fixed term of years or until his or her earlier death. The remainder interest in the GRAT is usually earmarked for the Grantor's descendants, either children or grandchildren. Because of the Grantor's retained interest (the right to receive income either in the form of an annuity or unitrust amount) the value of the gift to the designated remainder holders is less than the value of the property transferred to the GRAT, since the retained interest held by the Grantor is subtracted from the value of the transferred property. If the retained interest is not a "qualified interest" then it is valued at zero for purposes of calculating the value of the gift of the remainder interest to the Grantor's descendants, then that increases the amount of the gift that is subject to the federal gift tax. A "qualified interest" is either a qualified annuity interest (the right to

receive a fixed amount payable annually – GRAT) or a qualified unitrust interest (the right to receive a fixed percentage of the fair market value of the Trust's assets, determined annually – a GRUT).

If the property transferred to the GRAT appreciates more rapidly than the interest rate upon which the value of the Grantor's retained interest is calculated in the month of the creation of the GRAT, then all future appreciation in the GRAT's assets passes to the descendants essentially federal estate and gift tax free. If the federal estate tax laws are repealed, most of the value of the assets transferred into the GRAT will be returned to the Grantor anyway through the stream of annuity or unitrust payments. If the federal estate tax rules stay in place, all future appreciation in the transferred assets will escape taxation when the GRAT terminates, and the assets then pass to the Grantor's descendants.

Two recent decisions have helped to promote GRATs during this time of historically low federal interest rates which are used to calculate the Grantor's retained interest. (For example, the interest rate used to calculate the Grantor's retained interest in a GRAT in May 2003 is 3.82%)

One decision is the famous Walton case. In that case one of Sam Walton's heirs funded a GRAT with Walmart stock. A defined GRAT period was selected. The GRAT further provided that if the Grantor did not survive the selected term of years, then the annual GRAT payment was to continue to be paid to the Grantor's estate, until the selected number of years was paid in full. A Federal Tax Court approved this apparently simple arrangement after a strenuous fight by the IRS. The significance of the Walton decision is that a GRAT can be

structured to result in no gift tax when assets are transferred to the GRAT. The GRAT term will always be met, either with payments to the Grantor, or the Grantor's estate, which means that a term can be selected in conjunction with the applicable federal rate of interest, that produces no gift tax. The Walton decision endorses what is commonly called a zeroed out GRAT, so that no gift tax is paid or incurred when the GRAT is initially funded.

The second decision, from the 9th Circuit Court of Appeals (which does not govern Michigan,) made GRAT planning even more effective, when two lives were used. A husband created a GRAT in which he created a "qualified interest." He named his wife as a contingent beneficiary. He transferred non-voting shares of a closely held corporation to the GRAT worth slightly over \$4 million. The GRAT provided for an annual payout to the husband of 11.54% of the initial value of the stock transferred to the GRAT. The husband's GRAT provided that if he died prior to the end of the scheduled 15 year GRAT term, the annuity was then to be paid to his spouse for the balance of the GRAT term unless he revoked his spouse's interest in his GRAT. The wife created an identical GRAT, with identical provisions for her

husband. In valuing the stock transfers into each GRAT for gift tax purposes (i.e., when the GRAT terminated the assets would have passed to the couple's children,) each of the husband and wife reduced the value of their gifts using an annuity based on two successive lives, known as a dual life annuity. The result was a net gift from each to their descendants of \$35,959, i.e., a nominal gift in light of the \$4.0 million value of the stock transferred to each GRAT. The IRS argued that the contingent interest held by the spouse in each GRAT should not be used to determine the value of the gift of the remainder interest to the couple's descendants. The Court disagreed with the IRS on a variety of technical arguments. Consequently, a "two life annuity" can be used to substantially reduce the value of the gifted interest to the descendants.

The effect of a GRAT is to substantially transfer future appreciation in transferred assets, gift and estate tax free, to children or grandchildren. For the GRAT to work effectively, all that must occur is that the appreciation in the value of the assets held inside the GRAT must "beat" the interest rate used to calculate the gift when the GRAT was initially created.

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