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GRANTOR RETAINED TRUSTS (GRITS, GRATS AND GRUTS)

— by **Neil E. Harl***

The enactment of the latest statutory framework limiting estate freezes[1] and publication of the final regulations[2] have focused attention on the use of various planning techniques whereby property is placed in trust with an interest retained by the grantor. The major approaches are the grantor retained interest trust (GRIT), the grantor retained annuity trust (GRAT) and the grantor retained unitrust (GRUT).[3]

The objective is to reduce the gift to children or other remainder holders by retaining an interest for a period of years and hopefully to live beyond the period of the retained interest, with the property passing to children or others under favorable tax circumstances.

General Approach

In a typical situation, property is transferred in trust with an interest retained by the grantor for a specified number of years. A major concern with trusts involving interests retained by the grantor is how to value the retained interest. Under the 1990 legislation, retained interests in trust or term interests in property generally are valued at zero for federal gift tax purposes unless in the form of an annuity or unitrust interest.[4] Thus, if a transfer is made in trust by the transferor to or for the benefit of a member of the family, and the transferor or family member retains an interest in the trust, the amount of the gift is the value of the transferred property less the value of any interest retained by the transferor or family member. Unless the retained interest is a "qualified interest," the retained interest is valued at zero. A qualified interest is a right to receive at least annually a fixed amount (or a fixed percentage of the initial value of the trust), a right to receive at least annually a fixed percentage of the value of the trust property valued annually, or a non-contingent remainder interest if all other interests in the property are qualified interests.[5]

GRATS. A Grantor Retained Annuity Trust (GRAT) requires that the interest be an irrevocable right to receive a fixed amount payable to (or for the benefit of) the annuitant for each taxable year of the term.[6] A fixed amount is a stated dollar amount payable periodically, but not less frequently than annually, but only to the extent the amount does not exceed 120 percent of the stated dollar amount payable in the preceding year, or a fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal estate tax purposes, payable periodically but not less frequently than annually, but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year.[7]

> **Example**: U transfers property to an irrevocable trust, retaining the right to receive $10,000 in each of years 1 through 3, $12,000 in each of years 4 through 6, and $15,000 in each of years 7 through 10. The interest is a qualified annuity interest to the extent of U's right to receive $10,000 per year in years 1 through 3, $12,000 in years 4 through 6, $14,400 in year 7 and $15,000 in years 8 through 10, because those amounts represent the lower of the amount actually payable each year or an amount that does not exceed 120 percent of the stated dollar amount for the preceding year.[8]

The payment may be made after the end of the taxable year but must be made before the due date for filing the federal income tax return (without regard to extensions).[9] An annual non-cumulative right to withdraw a stated amount or an annual non-correlative right to withdraw a fixed fraction or percentage is not a qualified interest. Amounts in excess of the annuity amounts may be paid but the right to the excess amount is not taken into account in valuing the gift to the GRAT.[10] The determination of the value of the gift where the transferor retains a qualified interest requires the valuation of the retained interest under I.R.C. § 7520. The tables used in an I.R.C. § 7520 valuation utilize 120 percent of the midterm AFR in effect for the month in which the valuation date falls.

By adjusting the annuity payment amount or percentage and the term of the retained interest, it is mathematically possible to "zero out" the value of the remainder interest.[11] However, in one case where payments equalled 99.171 percent of the amount transferred to the trust upon creation, IRS took the position that a taxable gift had taken place nonetheless because of the possibility the grantor might die during the term.[12]

GRUTS. A Grantor Retained Unitrust amount (GRUT) requires that the transferor or applicable family member have an irrevocable right to receive payment at least annually of a fixed percentage of the net fair market value of

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the trust assets, determined annually. An exception is provided in the regulations for transfers of an interest in trust to a family member if the remainder interest in the trust qualifies for the federal gift tax charitable deduction.[13] I.R.C. § 2702 does not apply to the transfer of an interest in trust if the only interest in the trust, other than the remainder interest or a qualified annuity or unitrust interest, is an interest qualifying for the charitable deduction under I.R.C. § 2522 (a charitable lead trust). A transfer in trust is not subject to the valuation rules if the only property held in the trust is a personal residence of the term holder.[14]

Residence GRIT. Under a Grantor Retained Interest Trust (GRIT) involving the residence, the transferor uses the residence for a period of years then the residence is distributed outright to the beneficiaries of the trust, usually the transferor's children, or held in trust for other beneficiaries. The amount of the gift by the transferor is calculated by subtracting the value of the transferor's retained rights from the value of the residence.

> **Example:** X, a taxpayer age 65, transfers a residence valued at $100,000 to a trust and retains the right to use the residence for five years. The retained right is valued, under the actuarial tables, at approximately 36 percent of the value of the residence or $36,000. The gift would be approximately $64,000 which would come out of the unified credit. The federal gift tax annual exclusion would not be available inasmuch as the gift is a future interest.[15]
>
> If the transferor dies after the end of the period of retained use of the residence, the amount of the gift ($64,000) would be added back into the estate, not the value of the residence at death (probably $100,000 or more). This is the desired outcome.
>
> If the taxpayer dies before the end of the period of retained use of the residence, the value of the residence itself is included in the transferor's estate at its date of death value (or as of the alternate valuation date).[16] This is not the desired result, but the transferor is left no worse off than had ownership of the residence been retained.

A taxpayer may create only two personal residence trusts. Trusts holding fractional interests in the same residence are treated as one trust.[17] A personal residence trust is prohibited from holding any asset other than one residence to be used as a personal residence of the holder of the term interest. The trust may hold proceeds payable as a result of damage, destruction or involuntary conversion of the residence. The proceeds must be reinvested within two years in a personal residence.[18] The residence must not be occupied by anyone other than the taxpayer, a spouse or dependent and must be available to the taxpayer as a personal residence. Expenses of the residence may be paid directly by the taxpayer as term holder. A trust will not qualify as a personal residence trust if sold or otherwise transferred or used as something other than a personal residence.

A personal residence may include adjacent land not in excess of that which is reasonably appropriate for residential purposes.[19]

> Example**:** M conveys 160 acres of farmland including a residence and business outbuildings and 155 acres of cropland to a trust, retaining a term interest in the trust. The trust is not a personal residence trust because it includes assets in excess of what is reasonably appropriate for residential purposes. A personal residence is the principal residence of the taxpayer as term holder (as defined in I.R.C. § 1034), one other residence (as defined in I.R.C. § 280A(d)(1) but without regard to I.R.C. § 280A(d)(2) or (3)), or an undivided fractional interest in either of the above.

QPRT. A "qualified personal residence trust" provides additional flexibility.[20] A qualified personal residence trust (QPRT) is similar to personal residence trusts with the same definition as to personal residence.[21] A QPRT is permitted to hold assets other than the personal residence for certain time periods. Cash can be held in a separate account not exceeding what is required for payment of trust expenses, including mortgage payments, incurred or reasonably expected to be paid within six months from the date the cash is contributed to the trust, improvements to be paid within six months from the date of contribution to the trust, purchase of an initial residence within three months of the date of the contribution if the trustee has previously entered into a contract for the purchase, and purchase of a replacement residence within three months from the date of the contribution provided the trustee has previously entered into a contract for the purchase.

Excess cash must be distributed to the term holder on a quarterly basis and, on termination of the term interest, must be distributed to the term holder within 30 days.[22] A QPRT is also permitted to hold improvements to the residence, proceeds from sale of the residence and insurance policies and insurance proceeds payable as a result of damage to the residence.

A QPRT must provide that if the residence ceases to be used as a personal residence of the term holder, it ceases to be a QPRT.

A trust permitting the proceeds of sale to be held in the trust must provide that the trust ceases to be a QPRT not later than the earlier of two years from the date of sale, the termination of the term holder's interest in the trust, or the date on which a new residence is acquired by the trust.

Within 30 days after the date on which the trust ceases to be a QPRT, the assets must be distributed outright to the term holder or the assets must be held for the balance of the term in a trust meeting the requirements of a grantor retained annuity trust (GRAT), a grantor retained unitrust (GRUT) or a grantor retained interest trust (GRIT).

Using property after the term interest

If the grantor desires to continue using the property after the expiration of the term interest (which could well be the case for a farm or residence) the grantor could enter into a lease arrangement with the holder or holders of the remainder interest, after the end of the term interest for a fair and customary rental.[23] To avoid inclusion of the property in the grantor's gross estate, the grantor should avoid remaining an income beneficiary of the trust, or retaining control over the distribution policies of the trust including the power to sprinkle income, the power to accumulate income (especially if the income would pass to a third person), the power to invade principal, the power to alter or amend the trust instrument, and the power to terminate the trust.

Generation skipping

If a transfer is made to a GRIT, GRAT or GRUT, allocation of the $1 million GST exemption to the property is not effective before the close of the "Estate Tax Inclusion Period" which is the same as the retained income period.[24] Therefore, a GRIT, GRAT or GRUT cannot be used to leverage the $1 million GST exemption. If grandchildren take the remainder interest only because their parent died during the period of the term interest, the transfer is a generation skipping transfer subject to GST tax on the date the trust was created.[25]

FOOTNOTES

[1] Revenue Reconciliation Act of 1990, §§ 11601, 11602, Pub. L. 101-508, 104 Stat. 138-490 (1990). See generally 6 Harl, *Agricultural Law* § 46.04[2] (1993).

[2] Treas. Reg. § 25.2702, T.D. 8395, Jan. 28, 1992.

[3] See, e.g., Scanlon, GRITS, GRATS, GRUTS: A Phoenix Rises From the Ashes of Section 2036(c), Twenty Seventh Inst. on Estate Planning, Jan. 5, 1993.

[4] I.R.C. § 2702(a)(2)(A). See Ltr. Rul. 9239015, June 25, 1992 (grantor retained annuity trust was qualified annuity interest to extent of right to receive fixed amount per year for two year term or until donor's death, if earlier).

[5] I.R.C. § 2702(b).

[6] Treas. Reg. § 25.2702-3(b).

[7] Treas. Reg. § 25.2702-3(b)(1)(ii).

[8] Treas. Reg. § 25.2702-3(e), Ex. 2.]

[9] Treas. Reg. § 25.2702-3(b)(1)(i).

[10] Treas. Reg. § 25.2702-3(b)(1)(iii).

[11] See Ltr. Rul. 9239015, June 25, 1992.

[12] *Id*.

[13] Treas. Reg. § 25.2702-1(c)(3).

[14] See Ltr. Rul. 9151046, Sept. 26, 1991 (proprietary lease and shares in cooperative housing corporation qualify as personal residence; test is whether requirements of I.R.C. § 1034 or I.R.C. § 280A(d)(1) met).

[15] Treas. Reg. § 25.2503-3(a).

[16] I.R.C. § 2036(a)(1).

[17] Treas. Reg. § 25.2702-5(a).

[18] Treas. Reg. § 25.2702-5(b).

[19] Treas. Reg. § 25.2702-5(b)(2).

[20] Treas. Reg. § 25.2702-5(e).

[21] Treas. Reg. § 25.2702-5(c)(2).

[22] Treas. Reg. § 25.2702-5(c)(5).

[23] Compare Est. of Barlow v. Comm'r, 55 T.C. 666 (1971), *acq*., 1972-2 C.B. 1, with Est. of Nicol v. Comm'r, 56 T.C. 179 (1971) (farmland rented to daughter and son-in-law under five year crop share lease included in donor-lessee's gross estate). See also Est. of Maxwell v. Comm'r, 98 T.C. No. 39 (1992).

[24] I.R.C. § 2642(f)(3).

[25] Ltr. Rul. 9047028, Aug. 27, 1990.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ANIMALS

EXOTIC ANIMALS. The defendants owned red deer, Barbary sheep, and ibex on their ranch. The Colorado Wildlife Commission alleged that the defendants' animals were nonnative wildlife and that the defendants had violated Colo. Rev. Stat. § 33-6-114(3) for failing to keep the wildlife within the physical boundaries of their ranch. The animals were declared a public nuisance and the defendants enjoined from violating the statute and regulations. The court upheld the injunction, holding that the evidence supported the finding that the animals were nonnative wildlife in Colorado and that the failure to keep the animals within the ranch was a detriment to native Colorado wildlife. **Colorado Div. of Wildlife v. Cox, 843 P.2d 662 (Colo. Ct. App. 1992)**.

HORSES. The defendant was convicted of negligent endangerment for riding a horse while intoxicated. The defendant had given a ride to a child and the child was killed when the horse reared over and fell on the child. The court held that the jury was shown sufficient evidence to support the verdict where (1) the defendant's blood alcohol level was high enough to impair judgment and (2) the defendant was warned that the horse did not like to have more than one rider. **State v. Larson, 843 P.2d 777 (Mont. 1992)**.

BANKRUPTCY

GENERAL

DISCHARGE. The debtor was a partner in a horse breeding and racing business and had obtained secured loans from a creditor. The creditor sought to have the loans declared nondischargeable because of fraud by the debtor in making financial statements and for the unauthorized sale of collateral. The court held that the creditor failed to prove that the financial statements were false when made but that one loan was nondischargeable because the debtor had sold the collateral without prior consent of the creditor and without payment of the proceeds on the loan. ***In re* Wolfson, 148 B.R. 638 (Bankr. M.D. Fla. 1992)**.

EXEMPTIONS

AVOIDABLE LIENS. In 1975, the debtors had granted a nonpurchase money, nonpossessory security interest in several pieces of farm equipment, including two tractors, a shredder and two trailers. The debtors paid off the loan secured by the equipment. In 1979, between the date of enactment of the Bankruptcy Reform Act of 1978 and the effective date of the act, the debtors granted another nonpurchase money, nonpossessory security interest in the same equipment. The debtor sought to avoid the 1979 lien