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## Guest Article

# IRS Finalizes GRAT Regulations

## New Provisions Favor Taxpayers

By Jeffrey A. Baskies

In response to the now-famous *Walton* case, the IRS has changed the regulations under Sect. 2702 of the Internal Revenue Code applying to grantor retained annuity trusts (GRATs) and grantor retained unitrusts (GRUTs). (*Estate of Walton v. Commissioner*, 115 TC 589 (2000).)

The regulations, which are now final, are effective for trusts created after July 25, 2004.

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The new regulations address a key planning opportunity: An annuity or a unitrust amount which is payable for a specified term of years (e.g., 10 years), and continues to pay out to the grantor's estate if the grantor dies before the expiration of the term, is a qualified interest for the entire specified term, and it should be valued as a 10 year term interest without regard for the possible death of the grantor prior to the end of the

term.

### GRATs And GRUTs

GRATs and GRUTs became estate planning tools with the enactment of Chapter 14 and Sect. 2702 of the Code in particular. They are successors to the old grantor retained income trusts, which the Service addressed by enacting Sect. 2702. GRATs and GRUTs work as follows: A client creates an irrevocable trust and retains for himself a qualified income interest (defined as either a right to receive a fixed amount each year - annuity interest - or a right to receive a fixed percentage of the trust principal each year - a unitrust interest). The client then designates someone (the remainder beneficiary) to receive the remainder interest at the end of the term.

If the retained interest were not a qualified interest, then the client would be considered to have made a gift of 100 percent of the value of the property transferred to the trust as provided in Sect. 2702 of the Code. However, if the retained interest is a qualified interest, then the value of

the gift is determined by subtracting from the total value of the property transferred an amount equal to the present value of the retained interest. The IRS has promulgated tables under Sect. 7520 of the Code for purposes of valuing retained qualified interests.

Treasury Regulations also have been promulgated under Sect. 2702, which detail the processes for valuing qualified interests and determining what constitutes qualified interests. These regulations, and the examples thereunder, were the subject of much debate and consternation for practitioners.

Example 5 of Treas. Reg Sect. 2702-3(e) was the focal point of much of this consternation. That example read: "A transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust payment for 10 years *or until A's prior death*" (emphasis added).

The emphasized portion above proved the most controversial. As a result of the "or" qualifier in the example, the IRS's position was that any client creating a GRAT had to value his interest as the shorter of the set term or the period ending with the client's death. As a result of this approach, the value of the retained interest was less than it would have been if the value were solely that of the retained fixed term. As a consequence, the value of the remainder interest (the gift) went up.

As a further consequence of the IRS's position in Example 5, it was impossible to create a retained interest equal to 100 percent of the property transferred, and thus it was impossible to "zero-out" the taxable gift value in a GRAT. The argument was that there must always be some value ascribed to the potential death of the grantor during the term.

Example 6 of Treas. Reg Sect. 2702-3(e) was similar to Example 5. The facts were the same, except that if the grantor died within the 10-year term, the unitrust amount was to be paid to the grantor's estate for an additional 35 years. The example stated that the grantor's interest was a qualified unitrust interest to the extent of the right to receive the unitrust amount for 10 years or until the grantor's prior death.

### The *Walton* Case And The IRS's Response

In *Walton*, the U.S. Tax Court considered a situation involving a challenge to Example 5. A member of the Walton family (of the Wal-Mart fortune) created a GRAT under which she received an annuity interest for a fixed term of two years. At the end of the term, the trust assets passed to the remainder beneficiaries. The GRAT provided that if the taxpayer died before the expiration of the two-year term, then the annuity interest would be paid to her estate for the remainder of the term.

The taxpayer argued that her retained interest in the GRAT should be valued based on her retained two-year term without regard for her possible death - ignoring Example 5. As a result, the value of her interest should be zero. The IRS took the position that Example 5 applied and the taxpayer's retained interest had to be valued considering her possible death, and thus could never be zero.

The case made its way to the Tax Court in 2000. After considering the history of Sect. 2702 of the Code, the Tax Court held that Example 5 was wrong. The court found it was an unreasonable interpretation and invalid extension of Sect. 2702.

In 2003, the IRS announced that it was acquiescing in the holding in *Walton*. (Notice 2003-72, 2003-44 IRB 964.) Now, the Service has issued new regulations to revise Example 5 and Example 6 of Reg. Sect. 25.2702-3(e) to conform to the *Walton* decision.

Under the examples as revised, an annuity or a unitrust payable for a specified term of years to the grantor, or to the grantor's estate if he dies before the expiration of the fixed term, is a qualified interest for the entire fixed term. Thus, in Example 5, the interest of A (and A's estate) to receive the unitrust amount for a specified term of 10 years qualifies as a unitrust interest for 10 years - and by extension a GRAT interest would do the same. Further, in the new Example 6, the unitrust interest is a qualified interest for a full 10-year term. However, the right of A's estate to receive the unitrust amount for another 35 years after the expiration of the 10-year term, if A dies within the 10-year term, is not a qualified interest and is ignored.

### Conclusion

As a result of the *Walton* decision, the IRS's acquiescence and the new final regulations being promulgated, planning with GRATs and GRUTs has become more certain and more "taxpayer-friendly." There are powerful opportunities to shift assets via these planning techniques, especially GRATs. With interest rates still historically low, the use of GRATs should be investigated with clients of significant wealth.

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