

Proposed Regs. Solve GRAT Estate Tax Inclusion Dilemma



The grantor retained annuity trust (“GRAT”)¹ is a standard estate planning technique for transferring substantial family wealth with little or no gift tax.² A GRAT effectively transfers to other family members—without gift tax—the excess of the total investment return on the trust assets over the Section 7520 rate of return, for a stated term of years.

The Treasury has now proposed Regulations³ that would resolve favorably the major uncertainty that has plagued GRATs for years—the estate (and income) tax treatment of the trust assets if the grantor dies during the reserved annuity term. These Proposed Regulations should, when finalized, make GRATs even more attractive as a gift-giving technique for wealthy clients.

Background

A grantor retains an annuity interest in a GRAT for a set period of years. All or part of the trust assets must, therefore, be included in the grantor’s gross estate if the grantor dies during the reserved annuity term. A question has arisen in recent years whether all or some portion of the trust assets, or some other property is included in the grantor’s gross estate if the

grantor dies during the reserved annuity term of the trust.

Starting in 1993, the IRS issued several private rulings and similar guidance that included the entire value of a GRAT in the gross estate of a grantor who died during the reserved annuity term of a GRAT, under Section 2039(a), on the theory that the reserved annuity interest was taxable under that section.⁴ This analysis produced two potential problems for GRATs.

First, inclusion of the trust under Section 2039(a) meant that the entire trust would always be included in the grantor’s gross estate if he or she died during the reserved annuity term. There was no basis for partial trust inclusion under Section 2039(a), even if the trust assets had very substantially appreciated during the reserved annuity term.

Second, it was unclear whether a basis adjustment was made in the underlying trust assets on account of the premature death of the

grantor. Section 2039(a) includes in the grantor’s gross estate “the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent. . . .” The annuity, rather than the underlying assets, might therefore receive a basis adjustment on account of the grantor’s death, which might not result in reduced capital gains taxes when the underlying assets were themselves thereafter sold or exchanged.

Alternatively, some practitioners believed that the GRAT should be treated like a charitable remainder annuity trust, and that the grantor’s gross estate should include a portion of the trust assets (up to 100%) that would be required to produce an income interest equal to the annuity, determined under the Section 7520 actuarial tables in effect on the date of death.⁵ This analysis would leave open the possibility that less than 100% of the value of the trust assets would be included in the gross estate of a grantor who died during the trust term. It would also assure that the underlying trust assets would receive a basis adjustment to their fair market values on the date of the grantor’s death.

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