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Grantor Retained Annuity Trusts (GRAT) Are in the News Again

Before we get into the nuts and bolts of a recent District Court Case, let's take a moment to discuss GRATs. First of all, with the new tax law the estate tax exemption is \$11.2 million. If you are married, and elect portability, then the exemption is ...

Craig Smalley • Jun. 04, 2018

Before we get into the nuts and bolts of a recent District Court Case, let's take a moment to discuss GRATs. First of all, with the new tax law the estate tax exemption is \$11.2 million. If you are married, and elect portability, then the exemption is doubled to \$22.4 million. That being said, today GRATs are used to pass assets. For example, let's say that you own a business. You want to sell the business to your children. Let's say that you project the value of your business in 15 years will be \$10 million. You would then start a GRAT. The GRAT would have a term of 15 years. Your children would pay the annuity up to \$10 million over 15 years, and the GRAT would end. The GRAT would freeze the asset from the taxable estate. The caveat is if you die while the GRAT is in effect, then the remaining value of the GRAT is added back to your taxable estate.

Under IRC §2702, in valuing interests in trusts held by the transferor or applicable family members after the transfer of an interest in trust to a member of the transferor's family, IRS tables that are ordinarily used to value trust interests are disregarded, and retained interests are valued at zero (the zero value rule) unless they take a form comparable to an annuity or unitrust interest. Thus, subject to the exception for an annuity or unitrust interest, IRC §2702 generally treats the grantor

as making a gift of the full value of the property even though a child or other person will get the remainder only after a set number of years.

A trust in which the grantor retains a “qualified annuity interest” is known as a grantor retained annuity trust (GRAT). A qualified annuity interest is any interest that consists of the right to receive fixed amounts payable not less frequently than annually, and that meets all the additional requirements of Reg § 25.2702-3(b) and Reg § 25.2702-3(d). For example, the GRAT’s governing instrument must fix the term of the annuity interest, and the term must be (a) for the life of the term holder, (b) for a specified term of years, or (c) for the shorter (but not the longer) of those periods. The value of a qualified annuity interest may be subtracted from the value of property transferred to the trust in determining the amount of the taxable gift made by the transferor in establishing the trust (i.e., the annuity does not have to be valued at zero under the zero value rule of IRC §2702).

Reg § 20.2036-1(c)(2)(i) requires that transferred GRAT property be included in a decedent’s gross estate under IRC §2036 where the decedent retains an annuity interest and dies before the expiration of the GRAT term.

Under IRC §2036, an individual’s gross estate includes property he transferred during his life if he retained for life: (a) “the possession or enjoyment of the property, or the right to the income from the property,” (IRC § 2036(a)(1)) or (b) “the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.”^[1]

In *Badgley v. US*, the petitioner had an interest in a partnership. The petitioner started a GRAT, to pass the interest in the partnership to her kids. At least as early as 2002, the income generated by the Y&Y Co. partnership was sufficient to fund Patricia’s quarterly annual annuity payments. Between 2002 and 2012, Y&Y Co. allocated half of its income to the GRAT; the GRAT’s share of Y&Y Co. income was larger than Patricia’s annual annuity of \$302,259. Y&Y Co. also made cash distributions to the GRAT during this time that ranged from \$435,400 to \$730,000.

In November of 2012, the grantor of the GRAT died. The last payment to the GRAT was in September of 2012. When the estate tax return was done, the total value of the GRAT was added to the taxable estate. The taxes were paid, and executrix of the estate petitioned the IRS for a refund of the taxes paid as the result of the GRAT being added to the estate. The IRS neither denied nor issued the refund, leaving the executrix to file suit in District Court.

She noted that there was a distinction between “a fixed annuity payment payable out of transferred property” on the one hand, and the retention of a “right to income” on the other, and contended that IRC § 2036 applied only to the latter. She reasoned that (1) income and a fixed annuity payment were distinct because the former fluctuated while the latter did not; (2) a right to income connoted an “ascertainable and legally enforceable power” to receive income, which Patricia lacked; and (3) Patricia’s annuity could have been satisfied with income and principal, or principal only. Accordingly, the Executor claimed that IRS improperly included the GRAT in calculating Patricia’s gross estate, and the Executor was entitled to a tax refund.

On the other hand, IRS moved for summary judgment, arguing that IRC §2036 applied to the GRAT and that Reg § 20.2036-1(c)(2)(i) was valid. IRS argued that IRC §2036(a)’s “possession or enjoyment of” or “right to income” language applied to the GRAT for two alternative reasons: (i) because Patricia, the decedent, reserved a right to annual annuity payments from the GRAT, which she created with her one-half share in Y&Y Co. (the partnership); and (ii) because Patricia possessed and enjoyed the property because she retained “other interests and powers” in Y&Y Co., including her control over and personal benefit from Y&Y Co. activities. In arguing that Patricia’s fixed annuity qualifies as some possession, enjoyment, or right to income within the meaning of IRC §2036(a)(1), IRS relied primarily on three cases that gave a precedent. The IRS won the summary judgement.

In all reality, the last payment to the GRAT was made in September of 2012. The death occurred in November of 2012. The GRAT effectively ended after the last payment. There should be an appeal in this case.

[1] IRC§ 2036(a)(2)

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