

The **Estate Analyst**[®]

April, 2006

Good GRATs and Great GRATs

And An Interview With Robert C. Slane

By Robert L. Moshman, Esq.

“Oh! I should have used a GRAT!”

That’s a comment that an estate planner might make after falling into a pattern of planning that always relies on other techniques. Have GRATs become the V-8 of the estate-planning world?¹

Even the most experienced of estate planning professionals have to constantly review available techniques to avoid processing every estate the same way. With so much attention on family limited

partnerships (FLPs), other techniques may be out of sight and out of mind.

One such technique that may get overlooked is the mundane GRAT—a modern innovation borne of our tax code which has matured into one of the most reliable techniques that many estates can utilize.

But today’s grantor retained annuity trust is not your grandfather’s GRAT.

Presented With Our Compliments

GRATs evolved into highly effective tools over the past decade and overcame an erroneous Treasury Regulation in, *Walton v. Commissioner*, 115 T.C. 589 (2000). As a result there are some great GRATs such as the SuperGRAT that “zero out” all estate tax, or the SOGRAT, a patented technique that is ideal for working with nonqualified stock options.

Let’s review the basic mechanics of the GRAT and these innovative variations. And in reviewing the SOGRAT, we are most fortunate to have had several questions answered directly by Robert Slane, the estate planner who created this technique in 1997.

GRAT Origins

Dig deep enough into any modern trust arrangement and you’ll find yourself in feudal England where the Franciscan Friars had a little problem. It’s tough to make ends meet when you take a vow of poverty that precludes the ownership of real property. The solution was a system of “uses” that distinguished “ownership” from the “beneficial use” of property.

Enter the lawyers. Could this “use” concept help avoid taxes? Why yes! By dividing legal and equitable title, one could simply transcend unnecessary transfer taxation. Legislators began work to close this loophole at once, thus beginning a 500-year game of cat and mouse that has shaped modern trust law.

Flash forward to the 1980s and a new generation of lawyers had refined the trust concept to the point where estate values could be effectively frozen by splitting beneficial trust interests between a grantor and a beneficiary.

Then Congress laid down the law! Specifically, it restricted dishonorable valuations of split-interest trusts by adding Chapter 14 to the Tax Code. One might have expected such a historic moment to warrant a law with a name like, “The Prevention of Insincere Freezing of Taxable Interests Act.” Regrettably, in a preoccupied and an unpoetic modern world, new laws have names such as the Omnibus Budget Reconciliation Act of 1990.

A Safe Harbor

Despite cracking down on estate-freezing techniques, Chapter 14 provided a beautiful safe harbor. The grantor retained annuity trust, better known as GRAT, is explicitly authorized under section 2702.

Once assets are placed in a GRAT, the respective interests of the grantor and the future beneficiary can be carefully measured using Treasury tables and taxed accordingly. The more valuable the grantor’s retained interest, the lower the value of the transferred interest.

The grantor of a GRAT receives annuity payments for a fixed term. Thus, if the assets placed in a GRAT grow faster than the rate assumed under Section 7520 (the Treasury’s valuation tables), the extra growth ends up belonging to the remainderman.²

Treasury regulations arrived in 1992. This apparently gave practitioners the comfort level to explore the limits of this safe harbor. By late 1993, the lawyers had gained the upper hand yet again.

By creating a GRAT with a short term of two or three years and a maximum rate of return, the valuation of the remainder can be reduced almost to zero.³

The GRAT was thought to be the golden chalice of estate tax planning, i.e., a way to reduce transfer taxation to zero. Authors called the new approach “SuperFreeze” at the time, but the term SuperGRAT is the name that has stuck.⁴

Zeroing In on Zeroing Out

Sometimes great art is not recognized at first. In 1913, the Parisian audience booed with contempt for Stravinsky’s “Rite of Spring.” The artistic community shunned Vincent van Gogh during his lifetime.

Similarly, SuperGRATs were not fully utilized for many years. The root of the problem was Reg. §25.2702-3(e), example 5, under which a grantor could retain no more than a “qualified interest” in a GRAT. This allowed for the potential that the grantor could die before the term of the annuity.

In a unanimous (13-0) *en banc* decision, the Tax Court rejected this interpretive dance step. Thus, on December 22, 2000, *Walton v. Commissioner* paved the way for lots of SuperGRATs.

But over the following six months, estate tax repeal became serious and on June 7, 2001, President Bush signed the Economic Growth and Tax Relief Reconciliation Act. [Editor’s Note: Again, the historic moment called for a name like the “Banishment of Death Tax Act,” but we’ll have to live with EGTRRA ’01.] And the years that followed were at the peak of the FLP frenzy that gripped the estate-planning community.

Yet all the while, the zeroed-out SuperGRAT from the early 1990s has remained eminently effective, sublimely simple, and comfortably anchored in its safe harbor.⁵

The “OPGRAT”

Terrific variations on the GRAT have been developed. Since a GRAT is most effective when highly appreciable assets are used to fund it, placing a new business or a significant amount of seed money to start a business into an “opportunity GRAT” or OPGRAT can work quite well.⁶

For instance, consider a situation where \$1 million is used to bankroll a young adult who is buying or starting a business or simply setting up an investment portfolio. Because there are large risks involved, extending these funds as a taxable gift which may then be lost is not a good idea. If the funds are instead placed in an “opportunity GRAT” (OPGRAT), any losses simply deplete the parent’s taxable estate.

If the venture succeeds, the potential for huge amounts of appreciation are present, but all of that future value is kept out of the parent’s estate and passes to the young entrepreneur free of transfer tax.

The OPGRAT approach is preferable to the alternatives (gifts, loans, loan guarantees, or equity investments). Several notes about this approach:

An OPGRAT must be funded with enough cash to fund the business venture as well as the annuity payments back to the grantor. Since this is a grantor trust, the tax on income generated by these amounts is taxed to the grantor and does not further burden the new venture.

Premature death of the grantor before the annuity term, but after the assets have appreciated, may mean inclusion of the OPGRAT in the grantor’s estate. Life insurance on the grantor’s life may be used to hedge against this possibility.

OPGRATs may not be suitable for a grandparent-to-grandchild transaction because allocation of the GST exemption takes place at the end of the annuity period under the ETIP rule.

Meet The SOGRAT

Nonqualified stock options have great potential to appreciate in value and are therefore an excellent candidate for inclusion in a GRAT. The founding father of the stock option GRAT or SOGRAT is Robert

C. Slane, AEP, CLU, who is president of the Wealth Transfer Group, Inc., of Altamonte Springs, Florida.⁷

Mr. Slane received intellectual property patent 6567790 for the stock option GRAT or SOGRAT. He graciously answered a number of questions for us which are summarized and paraphrased for clarity as follows:

Q: How did you get the idea for the SOGRAT?

A: The idea for the SOGRAT arrived while planning for a business executive in 1997. That led to extensive research and ultimately to the approach which I patented.

Q: How many estates have nonqualified stock options?

A: A better question would be “How many estates of top executives, have nonqualified stock options?” When that pool of top executives are considered, the vast majority of them will have nonqualified options.

Q: What makes a nonqualified stock option such a good asset for a GRAT?

A: Tremendous potential for appreciation in value is the key. Consider the increase in value of the Dow 30 over a 10-year period, from July, 1994, through June, 2003. Over that time period, 28 of the stocks rose by an average of 8.7%. By comparison, research has shown that during periods of low interest, when underlying stocks increased by 10%, nonqualified stock options have risen, on average by 18%. A highly appreciating asset like a nonqualified stock option is the perfect asset to use in a GRAT.

Q: The SOGRAT has received some attention. Is this because it has a charismatic name, or is it the right concept at the right time?

A: A little of each. but the concept simply makes sense because it is so effective. [Editor’s Note: There is a marketing element in having a patent, and many high-profile estate planners have created designer techniques with media-friendly acronyms. Mostly, these techniques have been trademarked, making the patented route for the SOGRAT somewhat less typical.]

Q: SOGRATs involve funding with nonqualified stock options. Would a GRAT with qualified stock options work? Would such a trust merely be less effective?

A: No! The SOGRAT is strictly for nonqualified stock options. It simply won’t work with a qualified stock option. A nonqualified stock option is an option that does not receive preferential tax treatment and is considered the equivalent of cash compensation.

Q: Should an estate that lacks non qualified stock options go out of its way to acquire them for the purpose of setting up a SOGRAT?

A: This isn't a valid question because nonqualified stock options are given as incentives to top executives. They can't be acquired on the open market. One would have to acquire them from the deceased executive to whom the options were granted.

Q: What size estate should be looking at GRATs and SOGRATS to make them worthwhile?

A: There isn't a definitive asset level. Any executive with significant numbers of assets that would be subject to transfer taxation can employ these techniques to share future value with beneficiaries with lower tax burdens.

Q: Is the SOGRAT effective for state estate tax burdens in states that have decoupled?

A: Yes, the SOGRAT is an estate-tax saving technique that removes assets from the grantor's estate before they appreciate in value.

Q: How does the SOGRAT compare with other estate-tax saving techniques such as the FLP?

A: The SOGRAT is much simpler and has no valuation issues. Remember, we're utilizing a safe harbor from the IRS and the annuity tables and factors the government has supplied. There's never a sure thing, but the SOGRAT has very little risk and has been thoroughly researched.

Q: One of the variations of the SOGRAT involves the grantor swapping out the options at the end, i.e., the grantor substitutes an equivalent value of assets into the GRAT for the remaining options just before the GRAT terminates and then exercises the options. Is this an invitation for IRS attack?

A: No, not at all. The SOGRAT is not an income-tax saving technique. Swapping out options is typically permitted for most GRATS. Why? Because the IRS still gets its money. The same income tax is paid. Nonqualified stock options are taxed to the executive who received the options regardless of who exercises the option. Income tax approaches to nonqualified stock options simply fail. They have even been attempted by some of the Big Six accounting firms without success.

Q: Is the latter approach intended to take advantage of a stepped-up basis?

A: No, SOGRATs are not about saving income tax. There is no step up in basis. An executive who dies and whose estate cashes in \$100,000 of options for \$1 million will report income in respect of a decedent (IRD).

Q: What are the odds of the complete repeal of the estate tax taking place on schedule?

A: Zero. There is absolutely no chance of it happening. If they had enough votes, it would have happened already. And while they've put off the issue, Hurricane Katrina took place and large Iraq war debts accrued.

Q: Are you working on any new patents? Can you give us any hints?

A: If I was, it wouldn't be prudent to tell you about it because of the way patent law works.

Technical References

1. V-8 is a juice made by General Foods that looks like tomato juice but which also contains the juice of carrots, celery, beets, parsley, lettuce, watercress, and spinach. In the classic V-8 ad, a consumer expresses regret at having missed the opportunity to drink a nutritious V-8. The GRAT should be a more mainstream tool of estate planning but may have been marginalized by attention on other techniques...or by misperceptions about their current status with the IRS.
2. This gives GRATs a distinct advantage over grantor retained unitrusts (GRUTs), which divide the excess growth between grantor and remainderman. GRUTs are another safe harbor that is pretty much a non-issue. In *GRATs v. GRUTs*, (1994), Jonathan Blattmachr detailed the superiority of GRATs, while GRUTs left remaindermen no better off than with a direct gift.
3. You don't want to completely zero out the remainder. During the interview with Robert C. Slane for this article, he explained that a completely zero remainder would mean no gift had been made at all, i.e., no transfer. So the GRAT should transfer at least \$.01.
4. One of the earliest mentions we can find to the SuperGRAT is an article, "Leveraging the SuperGRAT," by Gideon Rothchild, JD, CPA, which appeared in the February, 1994 issue of *The Practical Accountant*. A newer version of the article from 2000 can be found on *FindLaw* online.
5. For crystal clarity on this subject, see the superb 2003 outline prepared by Jay Waxenberg, "Estate Planning with GRATs after Walton," on the ABA website.
6. The OPGRAT is yet another estate-planning brainstorm from Nevada attorney Richard A. Oshins who recently co-authored "The Opportunity GRAT: OPGRAT" with CPA Michael J. Jones. This article covers other planning variables not included here.
7. Slane, Freeman and Simmons, *Efficient use of nonqualified stock options as a wealth transfer vehicle*, Estate Planning (Sept., 2005).