SCIN vs. Private Annuity

EXHIBIT 7.6

	SCIN	Private Annuity
Term of Payment	Determined by Seller (not to exceed life expectancy)	Life of Annuitant
Deductibility of Interest	Depends on Property	None
Buyer's Adjusted Basis	Purchase Price of Property	Sum of Annuity Payments Actually Paid
Seller May Retain Security Interest	Yes	Not Generally

Grantor Retained Trusts

Grantor retained trusts include Grantor Retained Income Trusts (GRITs), Grantor Retained Annuity Trusts (GRATs), and Grantor Retained Unitrusts (GRUTs). These trusts are irrevocable and are used to transfer assets from one family member to another (or some other loved one) over time while retaining an income stream for the grantor during the trust term. The value of the gift to the beneficiary is determined by reducing the FMV of the donated property by the value of the retained interest or income stream. This income stream can be in the form of an income interest, an annuity payment or a unitrust payment.

Key Concepts

1. Discuss the risks of creating a GRAT.
2. Who receives the annuity payment in a typical GRAT?
3. What is the value of a gift in a GRIT where the remainderman is a family member?

This technique allows for the transfer of an asset at a discounted gift tax value, since the beneficiary does not receive the property until the end of the trust term and the technique removes the future appreciation of the asset from the grantor's estate. It is generally successful in removing appreciating property from the estate as long as the grantor lives beyond the trust term. To be successful, the growth rate of the asset contributed to the trust must exceed the required interest rate, known as the 7520 rate.

Grantor Retained Income Trusts (GRIT)

Grantor retained income trusts are irrevocable trusts in which the grantor retains an income interest in the trust for the term of the trust. Thus, the grantor will donate property to the trust and the income from the asset will be distributed to the grantor during the term of the trust. At the end of the trust term, the remaining property is distributed to the beneficiary (remainderman).

These types of trusts are used to transfer property at a lower gift tax value to beneficiaries. The value of the gift equals the FMV of the property transferred minus the value of the retained annuity interest. The value of the income interest that is retained by the grantor equals the present value of the income stream based on the 7520 rate.

Notice that the valuation of the income stream does not have anything to do with the true income in the trust. The value of the retained interest is the same whether the contributed asset produces a lot of income or a minimal amount of income. As a result, non-income producing assets were often contributed to GRITs so that more appreciation could be transferred at a lower gift tax.

However, Chapter 14 of the Internal Revenue Code, which was added by the Revenue Reconciliation Act of 1990, severely limited the use of GRITS. Specifically, IRC §IRC Section 2702 values the retained interest at zero when the transfer is to a family member. The result of this is that a transfer (the gift) to a family member in a GRIT will be valued at 100 percent of the FMV. There is no offset for the retained income interest. While this code section greatly limits the benefits of the GRIT for inter-family transfers, the definition of family creates an opportunity that is discussed below. Family is defined as a spouse, lineal descendants of the grantor or the spouse, any siblings or a spouse of a sibling.

IRC Section 2702 provides for exceptions to the zero valuation of the retained interest for a retained interest of a personal residence (see discussion of QPRT), or an annual annuity or unitrust payment (see GRAT and GRUT). The limitations under this code section are one of the primary reasons that GRATs are popular today, instead of GRITs.

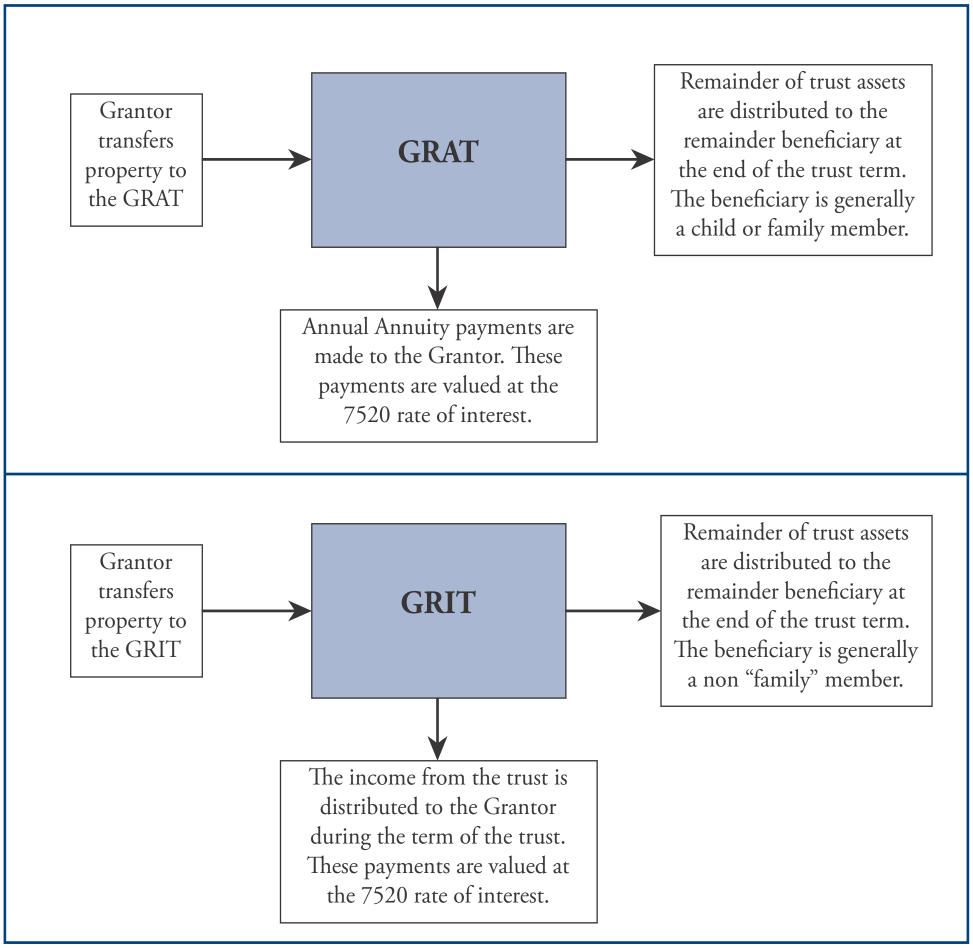
As mentioned above, the definition of family for this code section allows for GRITs to be used when transfers are to be made to "non-family" members. This type of transfer could benefit couples who are not married, since the partners would not be considered family members of each other. In these situations, the GRIT continues to be feasible. With the Supreme Court striking down DOMA (Defense of Marriage Act), GRITs are no longer an effective planning technique for spouses of same-sex marriage. However, they remain viable for unmarried couples.

Grantor Retained Annuity Trust (GRAT)

A **grantor retained annuity trust (GRAT)** is an irrevocable trust that pays a fixed annuity to the grantor for a defined term and pays the remainder interest of the trust to a non-charitable beneficiary at the end of the GRAT term. The GRAT is funded by the grantor with a transfer of property, and the annuity can be a stated dollar amount, fixed fraction, or a percent of the initial fair market value of the property transferred to the GRAT. The following exhibit illustrates the formation and application of a GRAT and provides a comparison to a GRIT.

FORMATION OF A GRAT V. GRIT

EXHIBIT 7.7



Gift and Estate Tax Consequences

At the creation of a GRAT, assuming the retained annuity interest is payable to the grantor, the annuity portion is not subject to gift tax. However, the present value of the expected future remainder interest is a gift of a future interest subject to gift tax. The value of the remainder interest is determined by subtracting the present value of the expected future annuity payments from the fair market value of the original transfer to the GRAT. If the investment rate of return exceeds the Section 7520 rate, the GRAT will successfully pass wealth to the remainder beneficiaries.

EXAMPLE 7.12

Mike, age 55, transfers a business with a fair market value of $5,450,000 to a GRAT with a term of 10 years. Assume the Section 7520 interest rate at the date of transfer is 1.2% and Mike retains an annual annuity payment of $213,436 from the trust. The remainder beneficiary is Mike's son James. What is the taxable gift at the date of transfer?

N = 10 Years
PMT = $213,436
i = 1.2%
PV = $2,000,000

Fair Market Value of Asset	$5,450,000
Less PV of Annuity	$2,000,000
Taxable Gift	**$3,450,000**

Mike can use a portion of his applicable lifetime gift tax exclusion to transfer the asset to James, and if Mike outlives the GRAT term, the entire asset has transferred to James without being subject to any transfer tax.

The term of the annuity is defined by the grantor. The longer the term, the higher the present value of the annuity payments and thus the lower the value of the remainder interest for gift tax purposes. However, if the grantor of the GRAT dies during the annuity term, the amount necessary to replace the annuity payments specified in the GRAT, as of the grantor's date of death, is included in his gross estate under Section 2036. If this occurs, the grantor has not saved any transfer tax.

Appreciating Property

An appropriate time to consider using a GRAT is when the transferor holds property that is expected to appreciate at a rate greater than the Section 7520 interest rate applicable to the GRAT. At the end of the GRAT term, (provided the grantor survives the annuity term) the property will transfer to the remaindermen. In this situation, the grantor will have transferred the appreciated remainder interest in the property at a gift tax cost calculated using the present value of the remainder interest at the date of transfer.

EXAMPLE 7.13

In 2018, Eric, age 55, transfers $12,180,000 to a 10-year GRAT. The remainderman is Eric's only child, Andrew. Assume the Section 7520 rate is 1.2%. Eric retains an annual annuity payment of $106,718 yielding a present value of the retained interest of $1,000,000 and a future interest taxable gift of $11,180,000, against which Eric can use his applicable gift tax exclusion, and thus pay no gift tax.

PMT = $106,718
N = 10
i = 1.2%
PV = $1,000,000 (Present Value of Retained Annuity Interest)
Gift = $11,180,000
Value of Property Contributed to GRAT ($12,180,000) less Value of Retained Annuity Interest ($1,000,000) = Value of Remainder Interest ($11,180,000)

If the property transferred to the GRAT actually appreciates at 10% annually, the growth in excess of the assumed Section 7520 rate, 1.2%, will be transferred to the remaindermen transfer tax free. The following chart illustrates the growth of the property and the amount that will transfer to the remainder beneficiary using assumptions.

Assuming that all works as planned, (Eric lives through the 10 years and annually consumes the $106,718 annuity) Eric will transfer to Andrew $27,292,231, the value of the asset at the end of the GRAT term, by simply using his applicable gift tax exclusion in 2018.

Year	Beginning Balance	10% Growth	Annuity Payment	Ending Balance
1	$11,180,000	$1,220,000	($106,718)	$13,313,282
2	$13,313,282	$1,331,328	($106,718)	$14,537,892
3	$14,537,892	$1,453,789	($106,718)	$15,884,963
4	$15,884,963	$1,588,496	($106,718)	$17,366,742
5	$17,366,742	$1,736,674	($106,718)	$18,996,698
6	$18,996,698	$1,899,670	($106,718)	$20,789,650
7	$20,789,650	$2,078,965	($106,718)	$22,761,897
8	$22,761,897	$2,276,190	($106,718)	$24,931,368
9	$24,931,368	$2,493,137	($106,718)	$27,317,787
10	$27,317,787	$2,731,779	($106,718)	$29,942,848

Note that Eric could have only transferred $1,000,000 to the GRAT with the same annuity payment of $106,718, thus creating a zero value gift (the value of the annuity is $1,000,000, creating a remainder interest with a value of $0). At the end of the 10 year GRAT term the remainder interest would be $892,932. This amount will be transferred with no transfer tax and without any use of the applicable gift tax exclusion.

Risk

Upon creation of the GRAT, the greatest risk is the grantor's failure to survive the GRAT term, causing the value of the annuity payments specified in the GRAT to be included in the grantor's gross estate. However, this risk is minimal because if this occurs (ignoring transactional costs) the grantor is no worse off than if he had not created the GRAT. Without the GRAT, the property would also have been included in his gross estate.

Income Tax Consequences

A GRAT is subject to the grantor trust rules for income tax purposes. There are no income tax consequences on the initial transfer to the GRAT because for income tax purposes, the grantor is still deemed to own all of the assets in the GRAT. However, all trust income flows through to the grantor annually, and is included in the grantor's income, without regard to the amount of the distributions made to the grantor. The grantor's usual objective in establishing a GRAT is to remove appreciation potential of the assets from his gross estate while minimizing transfer taxes. Income tax savings is not the primary motivation to establish a GRAT, but is a nice feature for the transferee.

Grantor Retained Unitrust (GRUT)

Another device similar to the GRAT is a **grantor retained unitrust (GRUT)**. Instead of paying a fixed annuity, a GRUT pays a fixed percentage of the trust's assets each year as revalued on an annual basis. For example a 15 percent GRUT pays out 15 percent of the value of the assets in the GRUT every year. Since the value of the assets will change, the annual payment will fluctuate each year. The GRUT is less suitable for hard to value assets (e.g., real estate, businesses) because the annual revaluation requirement is cumbersome. Also, if the asset is appreciating faster than the Section 7520 interest rate it causes the annual payment to the grantor to increase each year, which defeats the objective of lowering the grantor's gross estate. For these reasons, GRUTs are used less frequently than GRATs in estate plans.

QUICK QUIZ 7.3

1. A SCIN payment terminates at the death of the buyer.
   a. True
   b. False

2. The value of a GRIT is calculated by using the FMV less the present value of the retained interest.
   a. True
   b. False

3. At the date a GRAT is funded, the value of the remainder interest is the excess of the value of the contribution to the trust over the present value of the annuity stream.
   a. True
   b. False

False, True, True.

Short-Term GRATs or Rolling GRATs

The major risk of a long-term GRAT is that the transferor does not outlive the GRAT term. To mitigate against this risk, a transferor could use a series of short-term GRATS or rolling GRATS where the excess of the GRAT payment over the needed amount for consumption is transferred to a new GRAT. While such a technique is possible, one risk is the potential change in the Section 7520 rate. Such a technique is much more complicated than a single, long-term GRAT. As you will discover in Chapter 13, the GST exemption can only be allocated to a GRAT at the end of the GRAT term, making a GRAT ineffective for leveraging the generation skipping exemption.

Transfer to an Intentionally Defective Grantor Trust (IDGT)

An **intentionally defective grantor trust (IDGT)** is an irrevocable trust that is used to freeze the value of assets transferred to family members or loved ones for estate tax purposes. A gift to an IDGT is a completed gift for estate and gift tax purposes, but the IDGT is treated as a grantor trust for income tax purposes. The trust is intentionally established as a grantor trust. The purpose of this structure is to transfer an appreciating asset to a family member while the trust income remains taxable to the grantor. This tax treatment of the trust income is an additional benefit to the transferee since the payment of income tax will reduce the grantor's gross estate. If the trust had to pay the income tax, it would reduce the value of the gift and the rate of income tax may be higher due to the narrow trust income tax brackets. Thus, the tax treatment is a additional "tax-free" transfer to the beneficiary.