The Estate "Melt": GRATs Are Only the Tip of the Iceberg

Combining a securities loan with a gift to a grantor retained annuity trust can deplete—not just "freeze"—a senior member's taxable estate with little or no gift tax consequences

MICHAEL N. GOOEN, TRACY A. SNOW, AND BRIDGET A. HARRIS

Grantor retained annuity trusts (GRATs) are typically used as an estate freeze technique, removing appreciation in excess of a fixed rate of return from the grantor's taxable estate. However, a strange brew that blends a GRAT with a securities loan can melt—not merely freeze—the grantor's taxable estate. This "leveraged GRAT" is ideal for families with a large concentration of a single stock owned by an irrevocable trust. The senior family member borrows a fixed number of shares from the trust, agreeing to pay back identical shares as well as any income earned on the shares in the interim. If the shares appreciate, the annuity payments the grantor receives from the GRAT will be insufficient to return the same number of shares to the lender trust, forcing the grantor to deplete his or her own estate to repay the securities loan.

Introducing the estate "melt"

In recent years, the low interest rate environment has created ideal conditions for families with large concentrations of wealth to engage in "estate freeze" transactions. The purpose of an estate freeze is to shift assets to the next generation at current valuations, minimizing or eliminating transfer taxes while removing future appreciation from the transferor's estate. One popular freeze technique—the grantor retained annuity trust (GRAT)—is specifically blessed by statute. A successful GRAT can result in the significant transfer of otherwise taxable wealth by an individual to his or her descendants or other beneficiaries with little or no gift tax consequences. However, a traditionally structured GRAT removes only future growth in value from a taxable estate. If the transferor already owns significant wealth in his or her individual name, an estate freeze will do nothing to shield that existing value from the estate tax.

This article proposes augmenting a GRAT with a securities loan—a transaction typically seen in the financial services industry. Typically, a financial institution holding a concentrated position in a particular stock, derivative, or other security will loan a portion of that position to a broker-dealer, so that the broker-dealer can meet its obligations in another transaction (e.g., to close a short sale of stock). A qualifying securities loan will not generate taxable gain or loss, either on the initial transfer or on the return of identical securities.[1]

By coupling a securities loan with a gift to a GRAT, a transferor can not only "freeze" but also actually "melt" his or her taxable estate, depleting significant value that had already accrued prior to the transfer of assets to the GRAT.

MICHAEL N. GOOEN is a partner of Lowenstein Sandler LLP and a Fellow of the American College of Trust and Estate Counsel (ACTEC). TRACY A. SNOW and BRIDGET A. HARRIS are associates of Lowenstein Sandler. Michael, Tracy, and Bridget all appreciate the music of Eric Clapton.

Example. Layla, a former estate planning attorney turned tech entrepreneur, created GMK, a dating service app that pairs wealthy individuals with terminally ill partners who do not plan on using their estate tax exclusion amount. Because Layla recognized the importance of proper planning during the initial stages of a business venture, she gifted the majority of the GMK equity—then valued at $10 million—to an irrevocable dynasty trust for the benefit of her family. Layla opted to "split" the gift with her husband, Eric, to use both of their combined exemptions from gift/estate and generation-skipping transfer (GST) taxes. GMK's growth during Layla's lifetime outpaced her expectations, ballooning to $50 million.[2] Largely as a result of her other successful business ventures, Layla's individual wealth grew correspondingly, creating a long-term estate planning challenge.

Layla died several years later, survived by Eric and their four daughters. Layla bequeathed substantially all of her estate (valued at $120 million) to a marital deduction trust for Eric. During the estate administration process, this marital trust diversified its holdings and now consists of relatively liquid assets. On the other hand, the trustee of the dynasty trust has continued to hold GMK—the cream of Layla's entrepreneurial efforts—and has simply let it grow.

No one alerted Eric to the tax consequences of Layla's success during her lifetime. Eric is now at a crossroads. He recognizes that his family faces a potential federal estate tax bill of nearly $50 million. He would like to reduce that tax liability before it's too late. Eric has considered philanthropy—acknowledging that his family has sufficient assets to endow a museum (or at least a little wing)—but the core of his plan is to pass substantial wealth to his daughters, ideally during his life. Eric remembers that Layla had been a proponent of GRATs during her days as an estate planning attorney. Eric meets with Layla's former partner, Pattie, so that he can learn more.

GRAT basics

Pattie explains that Eric could create a GRAT by making a gift in trust, retaining the right to receive a fixed dollar amount (in cash or in other assets) from the trust each year for a fixed term of years. For tax purposes, the value of the gift is the fair market value of the transferred property minus the actuarial value of the retained annuity interest.[3] At the end of the GRAT term, the GRAT's remaining balance, including any income or asset growth in excess of the amount used to fund annual payments to the grantor, passes to the grantor's designated beneficiaries, or to trusts for their benefit, free of gift, estate, and income tax.

The value of the GRAT gift is a function of the length of the GRAT term, the amount of the annuity retained, and a government-prescribed interest rate (the "hurdle rate"). The annuity and the GRAT term can be structured so that, based on the hurdle rate in effect for the month of the GRAT's creation, the value of the annuity retained by the grantor is close to or equal to the value of the gifted property—resulting in a zero or near-zero gift.[4] Consequently, there is virtually no tax risk in creating a GRAT.

If the gifted assets do not outperform the hurdle rate, the entire value of the GRAT will be returned to the grantor, who will be left in the same position as he or she would have been had he or she not created the GRAT. On the other hand, to the extent the GRAT assets keep on growing at a rate that exceeds the hurdle rate, there will be a positive remainder after the grantor has received all annuity payments. In this scenario, the remainder beneficiaries will receive the excess free of gift and estate tax—regardless of how much growth the GRAT assets have enjoyed.[5]

Pattie explains that a GRAT's benefit lies in "freezing" an asset's value for gift and estate tax purposes, allowing growth and income in excess of the hurdle rate to pass to the grantor's beneficiaries free of tax. The greater the appreciation and income generated by the GRAT assets, the greater the amount that will be available on a tax-free basis to the next generation.

For example, assume that Eric contributes $20 million to a GRAT that lasts for five years. For the month in which Eric makes the gift, the hurdle rate is 2.4%. The GRAT makes five annuity payments of $4,292,582 to Eric. At the end of the five-year term, any remaining GRAT assets will pass to a trust for the benefit of Eric's and Layla's daughters. Eric will be treated as having made a taxable gift of only $1.95. If the asset contributed to the GRAT grows at a 6% annual rate, the daughters' trust will receive over $2.5 million, tax free. If the GRAT asset grows at a 10% annual rate, the daughters' trust will receive over $6 million, tax free.

Eric likes the GRAT concept in the abstract, characterizing it as a "heads we win, tails we break even" proposition. Pattie cautions Eric that

1 See Section 1058.

2 We beg the reader's indulgence to assume that this business proposition is as lucrative as it is funny. We further ask the reader to assume that it is funny.

3 See Section 2702; Reg. 25.2702-1(b).

4 Walton, 115 TC 589 (2000), *acq.* Notice 2003-72, 2003-2 CB 964.

5 If the grantor dies before the end of the GRAT term, some or all of the GRAT assets will be includable in his or her gross estate for estate tax purposes.

while the GRAT may look wonderful tonight, two concerns dampen her enthusiasm for traditional GRATs as a long-term estate planning solution for Eric's family:

1. The traditional GRAT doesn't achieve Eric's goal of reducing his taxable estate: In the example, he starts with $20 million and ends with nearly $21.5 million.
2. To create any meaningful remainder, the GRAT assets have got to get better in a little while—and the diversified portfolio comprising Eric's taxable estate has limited appreciation potential.

Pattie asks Eric about the GMK stock. Eric notes that the GMK app's popularity has continued to surge and believes that GMK likely will go public within five years. Eric says, "I would rather use GMK stock to fund a GRAT anyday"—except that all of GMK's stock is already in the dynasty trust, sheltered from estate, gift, and GST taxes.

Eric asks Pattie about having the dynasty trust distribute the GMK shares—either to him (to fund a GRAT) or to his daughters. Pattie dislikes both ideas: A distribution to Eric would add the current GMK value to his already-robust taxable estate, and the GRAT would serve only to freeze that added value. A distribution to Eric's daughters would not create an estate tax problem at Eric's level, but would do so at the daughters' level, wasting the GST tax protection afforded by the dynasty trust.

Eric then asks Pattie whether he should purchase the GMK shares from the dynasty trust. Pattie points out that such a purchase would generate a sizable capital gains tax to the trust—and although the purchase would not augment Eric's taxable estate, he would simply be replacing the assets used to finance the purchase with the GRAT annuity stream.

Frustrated, Eric complains that a GRAT does not seem to live up to its billing as a great estate planning solution. Pattie smiles, replying: "It's in the way that you use it. If we arrange the dominos in a different direction, they'll fall in the right place." She proposes that instead of taking a distribution or purchasing the GMK shares, Eric should *borrow* the shares from the dynasty trust—much as a short seller of securities borrows shares from a financial institution.

As the short seller delivers the borrowed shares to its counterparty in the short sale, Eric can transfer the borrowed shares as a gift to a GRAT. In each case, the borrower assumes the economic risk that the shares will appreciate in value. Unlike the typical short seller, however, Eric hopes the shares he borrows will appreciate—because the loss his taxable estate suffers will benefit his family's dynasty trust. In essence, the leveraged GRAT not only "freezes" but "melts" his taxable estate, reducing its value to repay the securities loan.

Securities lending basics

Pattie explains that the Code provides a helpful roadmap in structuring a securities loan. Section 1058 distinguishes the (nontaxable) issuance and repayment of a securities loan from a set of taxable exchanges between the lender and the borrower. To qualify, the lender and borrower must enter into a written agreement that contains all of the following features:

- Requires the borrower to return to the lender securities identical to the transferred securities.
- Requires the borrower to pay to the lender amounts equivalent to all interest, dividends, and other distributions to which the securities' owner is entitled during the loan period.
- Does not reduce the lender's risk of loss or opportunity for gain in the transferred securities.
- Allows the lender to terminate the loan on notice of no more than five business days.[6]

If those requirements are satisfied, neither the initial transfer of securities by nor the return of shares to the lender triggers taxable income to the lender. Instead, the lender simply takes the returned shares at their original cost basis.[7]

Pattie notes that the main point of these requirements is to ensure that the economic benefits and burdens of the transferred securities remains with the lender at all times during the loan period. The "identical securities" requirement ensures that the lender will receive securities of the same class and issue—or at least equivalent securities in the event of a reorganization, recapitalization, or merger.[8] The requirement that the lender receive amounts equivalent to the return on the loaned securities ensures that the lender maintains the economic benefits of owning those securities—although for tax purposes, those payments will be considered fees for the use of property rather than dividends, interest, etc.

Certain dividends may be taxed to noncorporate holders at preferential long-term capital gains rates,[9] while such fees are taxed at ordinary income rates. That difference can be significant if the borrowed shares pay significant dividends. Moreover, there may be limits on the borrower's ability to deduct those dividend/interest

[6] Section 1058(b); Prop. Reg. 1.1058-1(b)(3).
[7] Section 1058(c).
[8] Prop. Reg. 1.1058-1(a)(1).
[9] Section 1(h)(11).

equivalent payments for federal and state income tax purposes. Fortunately for Eric, GMK does not presently pay dividends and does not anticipate doing so in the near term, so that issue is not a current concern for him.

Pattie notes that Section 1058 expressly addresses only the lender's tax consequences, not the borrower's. However, she expresses great confidence that neither the receipt nor the return of the borrowed shares will trigger taxable income to the borrower. When the loan is called or the term is complete, the borrower's promises end; the borrower returns the shares and promptly pays to the lender amounts equal to any dividends or other distributions paid on the shares during the term of the loan. At that point, the borrower, like the lender, is in no better or worse position economically than if he or she had not borrowed the shares. The borrower should realize no taxable gain or loss, any more so than if he or she had borrowed and returned an item of tangible personal property.

Pattie advises Eric that the securities loan agreement will require him to return GMK shares to the dynasty trust upon five business days' notice from the trustee, and should also state a maximum term that will apply if the loan is not called earlier. As a practical matter, this requirement makes Eric's relationship with the trustee of the dynasty trust a critical component of the GRAT's success or failure. If the trustee is hostile to Eric (either for personal reasons or because of competing beneficial interests), the trustee could call the loan early simply to stymie Eric's efforts to create a successful GRAT. While it is helpful for the dynasty trust trustee to maintain a slow hand, it is essential that there be no prearrangement between Eric and the trustee *not* to call the loan until the end of the GRAT term. Such an agreement would reduce the dynasty trust's opportunity for gain with respect to the securities in contravention of Section 1058, jeopardizing the favorable income tax treatment of the loan.

A GRAT's benefit lies in "freezing" an asset's value for gift and estate tax purposes, allowing growth and income in excess of the hurdle rate to pass to the grantor's beneficiaries free of tax.

Moreover, the IRS could construe such an arrangement as a constructive distribution of the GMK shares to Eric (arguably making Eric's return of the shares a gift, in whole or in part), or even as a badge of impermissible control over the dynasty trust that would risk inclusion of the dynasty trust's corpus in Eric's estate. Pattie offers to facilitate a meeting among Eric, the trustee, and the trustee's counsel so that they can review the purpose of the transaction and the trustee's rights and obligations under the proposed securities lending agreement.

Eric remains confused. "Pattie, I know that GRATs make distributions only once a year. What if the dynasty trust trustee does call the loan early? And if the GRAT is successful, it will give me fewer GMK shares than I borrowed—where do I get additional GMK shares to repay the loan? GMK is not a public company (at least not yet), so I cannot ask my broker to buy those additional shares."

Pattie explains that under the trust agreement governing the GRAT, Eric will have the right to purchase any asset owned by the GRAT in exchange for any other asset having the same current fair market value. Consequently, Eric always will have the right to reacquire the GMK shares, albeit at a higher price than the initial value if his GRAT "bet" succeeds.

Pattie reminds Eric that the GRAT is classified as a "grantor trust," so that any trade between Eric and the GRAT is disregarded for income tax purposes.[10] Thus, no matter how much appreciation the GMK shares experience during the GRAT term, Eric may reacquire those shares without capital gain recognition—either by the GRAT on the conveyance of the GMK shares or on Eric's conveyance of any asset he uses to pay the purchase price.

Estate melt in action

Pattie walks Eric through an example of a leveraged GRAT transaction:

Eric borrows 40,000 GMK shares from the dynasty trust, promising to pay back 40,000 identical shares (regardless of their dollar value at the time of repayment) at the expiration of a six-year maximum loan term, or, if sooner, within five business days of a demand by the trustee. At the time of the loan, the borrowed GMK shares are worth $20 million ($500 per share). As in the original example, Eric funds a five-year, zeroed-out GRAT based on a 2.4% hurdle rate. Eric retains the right to receive a $4,292,582 annuity for five years, reporting a taxable gift of $1.95.

At the end of the GRAT term, any remaining balance will pass to a continuing trust (the "remainder trust") for the benefit of Eric's daughters. Both the GRAT and the remainder trust are structured as grantor trusts in which Eric retains the power to reacquire the assets

[10] See Rev. Rul. 85-13, 1985-1 CB 184.

of either trust (including GMK stock) for cash or other assets of equivalent value. While Eric's daughters will be able to receive discretionary distributions from the remainder trust after the GRAT terminates, that trust will provide continuing protection from the daughters' creditors, as well as the benefit of having Eric remain liable for income taxes on the remainder trust's income.

Pattie asks Eric to assume that the GRAT will retain the GMK shares as its sole investment throughout the five-year term and that the GMK shares will appreciate by 20% annually during that time.[11] At the end of the first year of the GRAT term, when the shares are worth $600 each, the GRAT will distribute 7,154 shares to Eric (with a value of $4,292,400).[12] Throughout the remaining GRAT term, Eric will receive a decreasing number of GMK shares. At the end of the GRAT term, Eric has received a total of 25,678 GMK shares, leaving the remainder trust with 14,322 GMK shares (and a modest amount of cash respecting Eric's annual purchases to avoid fractional share distributions).

Eric then exercises his repurchase option to acquire the remaining 14,322 GMK shares from the remainder trust, paying $17,818,859.50 (based on the then fair market value of $1,244.16 per share) from his individual assets. Eric then conveys the 40,000 GMK shares (having a fair market value of $49,766,400) to the dynasty trust in full repayment of the securities loan.

To recap: Thanks to the growth in the GMK shares, Eric has turned a $1.95 GRAT gift into nearly $18 million of value for the remainder trust. Such a result in a typical (unleveraged) GRAT would be a spectacular success, but the result for Eric's family is even better. Thanks to the securities loan, the appreciation in the GMK shares has served double duty: It has both enhanced the value of a new family trust (which will not be subject to estate tax at Eric's death), *and* correspondingly reduced the value of Eric's (taxable) estate. Meanwhile, the dynasty trust has enjoyed the full economic benefits of the GMK share appreciation during the GRAT term. By "photocopying" the GMK growth, Eric has achieved all of his estate planning goals, at virtually no tax cost, in one fell swoop.

Pattie cautions that there is no case or ruling guidance that expressly addresses the income, estate, and gift tax treatment of the securities loan/GRAT combination. However, the Code and Regulations provide clear requirements for each component of the transaction, so that careful design and compliance should make it difficult for the IRS to challenge the plan as a whole.

Eric is very enthusiastic about Pattie's example, but has one lingering concern: What if the technique is "too successful"? Eric hasn't forgotten the fact that once he has made a gift, he can't get it back. Especially if GMK goes public, Eric anticipates that GMK's share value could appreciate by considerably more than 20% per year. If the GRAT or the remainder trust sells those appreciated shares in a taxable transaction, Eric will be liable for the capital gains tax as the trusts' grantor.

While that is a concern in any GRAT, Eric's fear is magnified here: The appreciation itself (whether or not realized in a liquidity event) represents a personal liability to him under the securities loan arrangement. Thus, the greater the appreciation in the GMK shares, the more he will have to provide out of pocket to repay the dynasty trust. At some point, he may view that cost as more of a threat to his livelihood than an estate planning benefit.

Pattie acknowledges Eric's concern, but has a solution to ease his worried mind. She proposes to design the GRAT remainder with a "cap," so that if the GRAT assets experience any appreciation above a specified amount, the excess will return to Eric rather than pass to the remainder trust. Consequently, Eric can be assured that repaying the securities loan will not deplete his estate beyond a certain point; he needs only to define his comfort zone at the GRAT's inception.

Conclusion

GRATs—while popular estate "freeze" vehicles with the potential to confer significant tax benefits on families with highly appreciating assets—are only the tip of the iceberg. Below the surface is a technique not customarily found in the estate planner's tool bag: the securities loan. By borrowing high-growth-potential securities from an existing irrevocable trust, and then gifting those securities to a GRAT, a donor can take advantage of his or her obligation to repay the trust in kind, converting appreciation into an intrafamily liability that drains value from the donor's taxable estate. What could possibly be better than an estate freeze? Coupling a securities loan with a GRAT can produce an estate "melt"—and thus make the best of the situation. ■

11 If the GMK share price does not outperform the 2.4% hurdle rate, the leveraged GRAT will have the same result as a typical (unleveraged) GRAT: Eric will receive all of the GMK shares as annuity distributions, allowing him to repay the dynasty trust in full but resulting in no benefit to the remainder trust.

12 To avoid the need to deal with fractional shares, Eric buys one additional GMK share from the GRAT, so that the GRAT can pay Eric the remaining $182 of the annuity distribution in cash and retain the extra $418.