MENDING WAYWARD WEALTH TRANSFER STRATEGIES

Jordan M. Ware

Winstead PC
401 Congress Avenue
Suite 2100
Austin, Texas 78701
512.370.2837
jware@winstead.com

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I. Introduction

A. In General.

To paraphrase the poet Robert Burns, the best laid plans of clients and their estate planning lawyers sometimes go astray.[2] Such is the case with wealth shifting strategies like GRATs, installment sales, and QPRTs. Sometimes we devise the ideal plan for our client but, due to the occurrence of unforeseeable circumstances or unanticipated factors, the plan no longer is appropriate and our client is left, in Burns' phrase, with "nought but grief an' pain." Sometimes the plan we devise and implement for the client works fine but unanticipated factors afford the opportunity to shift additional wealth for the client by modifying the plan in some respect.

B. Five Ways for Plans to Go Awry.

This paper focuses on the three wealth-shifting strategies mentioned above: GRATs, installment sales, and QPRTs. For each of them, this paper examines some or all of the following five things that can adversely affect a client's plan or that can create additional wealth-shifting opportunities by altering an existing plan:

- Bad design. The chosen planning technique is appropriate for the client, but there are problems in drafting the transaction documents, choosing the assets to use in the technique, structuring the transaction, etc.
- Economic changes. The economics of the transaction suggest a need for change; for example, the assets involved in the transaction have failed to appreciate or have appreciated more than expected, or due to interest rate changes the transaction is no longer optimal and its performance could be improved by the incorporation of current interest rates.
- Mortality changes. Someone's life expectancy (e.g., the grantor or a beneficiary) changes after the transaction is implemented, threatening the anticipated wealth shift.
- Client's wishes change. The client no longer wants the wealth shift that the transaction was intended to achieve or promises to provide (e.g., due to family changes from marriage, divorce, births, deaths, etc., lifestyle changes such as acquiring a new residence, a change in financial position, etc.).
- Bad administration. The client or his advisers have failed to administer the transaction appropriately, threatening the wealth shift or creating other problems.

C. Purposes of this Paper.

The purposes of this paper are to discuss some of the ways in which wealth-shifting transactions may go astray or may need to be modified to enhance their performance, to suggest potential solutions and planning considerations that may help when they do, and to suggest drafting strategies that may reduce, eliminate, or otherwise cope with problems and take advantage of opportunities. Many of the potential solutions and planning considerations discussed in this paper implicate various fiduciary duties of a trustee, such as the duty to act prudently, to treat beneficiaries impartially, and to refrain from self-dealing. Obviously, the trustee should take into account those fiduciary duties and all others in deciding whether to employ any strategy mentioned in this paper.

D. Disclaimer.

This paper is not intended to be, and should not be construed as constituting, the author's opinion with regard to any specific case or transaction or the author's legal or tax advice with respect to any specific case or transaction. The forms included in this paper are for illustrative purposes only and may not be appropriate for any particular client or for use in any particular case or transaction. These forms should be used only by competent counsel and only as illustrations.

II. Grantor Retained Annuity Trusts

A. In General.

1. Overview of GRATs.

Section 2702 of the Internal Revenue Code[3] specifically authorizes the grantor retained annuity trust, or "GRAT". A GRAT is a trust in which the grantor contributes assets to the trust and retains the right to receive an annuity for a term of years. The annuity interest can be expressed either as a dollar amount or as a specified percentage of the initial fair market value of the trust assets. When the retained term interest ends, the GRAT terminates and any remaining assets are distributed to the remainder beneficiaries. If the trust satisfies all of the requirements for a GRAT,[4] the grantor's retained annuity interest will be a "qualified interest" and, for purposes of determining the amount of the grantor's gift to the remainder beneficiaries, the value of the grantor's retained annuity interest will be determined under Section 7520.[5] If the trust does not satisfy the requirements for a GRAT, the grantor's retained annuity interest will not be a qualified interest and it will be valued at zero.[6] This means that the grantor will have made a gift to the remainder beneficiaries equal to the value of the property transferred to the trust, undiminished by the grantor's retained interest.[7] Generally, if the property transferred to a GRAT has an overall annual investment performance that exceeds the Section 7520 rate in effect at the time of the creation of the GRAT,[8] value will be shifted to the remainder beneficiaries free of gift tax. If the investment performance of the GRAT assets does not exceed the Section 7520 rate, all of the GRAT assets will be returned to the grantor in satisfaction (or partial satisfaction) of the grantor's retained annuity interest, and the grantor will be in the same position economically and tax-wise as if the GRAT had never been established.

If the grantor dies during the term of the GRAT, some or all of the GRAT assets will be included in the grantor's gross estate.[9]

A GRAT does not facilitate a leveraged use of a client's exemption from the generation-skipping transfer tax due to the "ETIP" rules under Section 2642(f).