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**Six Steps to a Marital Deduction for a *Walton* GRAT or
How I Learned to Love the Bomb**

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Introduction

The *Walton* case (*Walton v. Com.*, (2000) 115 T.C. 589), which sets forth how to reduce the gift element of a Grantor Retained Annuity Trust (a "GRAT" herein) to near zero, and the subsequent acceptance thereof by the IRS as announced in Notice 2003-72, 2003-2 CB 964, added a powerful tool to the estate planner's toolbox. However, with all due respect to the 1960s movie "Dr. Strangelove," a *Walton* GRAT for a married grantor can create an estate tax bomb, waiting to explode if the grantor dies prior to the termination of the term of the GRAT. It is, perhaps, an overstatement to compare such a result to the sight of Slim Pickens riding the bomb like a bucking bronco to its final destination. However, for most estate planning attorneys, the loss of the marital deduction for all properties held in the GRAT would be an unpleasant experience, sure to result in the need to notify one's professional liability insurance carrier of a potential claim.

If the grantor dies during the term of the GRAT, the standard *Walton*-style provisions will almost always result in (i) inclusion of all of the GRAT properties in the grantor's estate for estate tax purposes, and (ii) a situation in which that included GRAT property cannot qualify for the marital deduction.

Walton requires that the GRAT not terminate upon the grantor's death. Rather, the GRAT must continue for the full term, whether or not the grantor dies during the term of the trust. Since the GRAT continues, the property cannot return to the grantor's estate, where it could pass under the grantor's other estate planning documents in a manner designed to qualify for the all important marital deduction.

There are, however, six modifications to the standard *Walton* GRAT trust agreement which, if implemented correctly, will allow the GRAT to continue for the full term (complying with the *Walton* requirements) and qualify, if necessary, for the marital deduction in the grantor's estate.

Step 1: Continuation for the Entire Term

To be sure that the GRAT qualifies for *Walton*-type treatment (after all, the grantor will probably not die) the GRAT payment language must provide that the GRAT continues for the entire term, and that the payment of the GRAT Annuity continues the entire term, even if the grantor dies during that term. It is critical that one be clear that the GRAT will continue, and payments will be made, to the grantor, and if the grantor dies during the GRAT term, to the estate of the grantor. You will also want to be sure that you specify that any

payment made after the grantor's death will be prorated between the payees (the grantor and the grantor's estate on a daily basis).

Step 2: Restate the Payment Formula to Provide that All Income is to be Distributed

A basic requirement for marital deduction qualification is that all income must be paid, at least annually, to the surviving spouse. To comply with this requirement and still qualify for *Walton* type treatment, the payment formula contained in the GRAT must provide for the distribution of the greater of the (i) GRAT payment previously specified and (ii) the income of the GRAT. Of course, the payment must still be made to the estate of the grantor, as set forth in Step 1. In consequent steps, we will assure that such income is paid to the surviving spouse.

Some estate planning lawyers have expressed concern that changing the payment upon the death of the grantor to the greater of (i) the GRAT payment, normally calculated, and (ii) the income of the trust, would violate the 20% increase rule set forth in Reg. 25.2702-3(b)(1)(ii). However, that provision does not limit how much the payment to the grantor (or the grantor's estate) can increase in any one year. Rather, that provision limits the extent to which any such increase in GRAT payment can be taken into account in valuing the payments reserved to the grantor. The payments to the grantor can increase more than 20% in any one year, but only increases up to 20% can be taken into account for valuation purposes.

Step 3: Include Boilerplate Marital Trust Qualification Provision and Make them Applicable during the Term of the GRAT

Estate planners are accustomed to including certain standard "boilerplate" provisions for any marital deduction trust, such as the provision that the surviving spouse may direct the Trustee to make the properties productive of income. Upon the death of the grantor, the goal is to be sure that the trust terms applicable to the property held by the GRAT trustee are consistent with the allowance of a marital deduction. Thus, provisions such as the productive property language must be included and must be made expressly applicable to the GRAT during the remainder of the GRAT term.

Step 4: Clarification of Priority between the 105 Day Distribution Rule and the Income at Least Annually Distribution Rule

The GRAT regulations provide that payment of the GRAT annuity for a calendar year GRAT may be deferred until April 15th of the next year. Similarly, for GRATs which are drafted to provide that payment is to occur on each anniversary of the initial funding, payment may be deferred for up to 105 days after that due date. However, under the marital deduction rules income must be distributed to the surviving spouse at least annually.

Care must be taken that the marital deduction rule (annual distribution of income) has priority over the 105-day rule. An abundance of caution dictates an express statement that other provisions of the agreement and the applicable GRAT regulations are subject to the grantor's direction and that the

provisions of the GRAT qualify for a marital deduction in the event of the grantor's death during the GRAT term.

Step 5: Contemporaneous Execution of a Codicil Mandating Immediate Distribution of the GRAT Payment Received By the Estate

Steps 1 and 2 provide that if the grantor dies, the GRAT payment will continue but will be made to the grantor's estate rather than the grantor. The payment will be the greater of (i) the GRAT payment, normally calculated under the agreement, and (ii) the income of the GRAT.

Step 5 is to contemporaneously execute a Codicil to the Grantor's Will providing that any such payment so received will immediately be distributed to the grantor's surviving spouse. The surviving spouse will then be receiving all of the income of the GRAT on an annual basis, as required by the marital deduction regulations.

Some variation upon the amount to be distributed is probably permissible, and may be very advisable to satisfy the grantor. In virtually all short term GRATs, the GRAT payment, as normally calculated, will greatly exceed any income of the trust. Is it necessary that all of the payment received by the grantor's estate be distributed outright to the surviving spouse, or is it permissible to provide that only that the portion of the payment so received which represents income of the GRAT will be distributed outright to the surviving spouse?

For example, a two year GRAT created during September of 2005, providing for a 20% increase between the first and second payments, where the first payment is due upon the first anniversary of creation of the GRAT, will have a first anniversary payment of 49.00037% of the value of the property initially contributed to the GRAT. Almost certainly, the income of the trust for that first twelve-month period will be less than that large calculated GRAT payment.

While the GRAT must provide that in the event of the death of the grantor, the payment to the grantor's estate must be the larger of (i) the calculated GRAT payment and (ii) the income of the trust, the payment actually made will almost always be the calculated GRAT payment of 49.00037% of the initial value. In that event, the codicil could provide that the personal representative of the grantor's estate would immediately distribute the portion thereof representing income of the GRAT outright to the surviving spouse, and distribute the remainder thereof to a QTIP trust for the benefit of the surviving spouse.

Step 6: Provision for the GRAT Remainder in a Manner that Qualifies for a Marital Deduction

Finally, the GRAT must provide that at the end of the GRAT term, any assets remaining in the GRAT (after payment of all amounts due to the grantor or the grantor's estate) must be distributed in a manner that otherwise qualifies for a marital deduction.

That may be in the form of a distribution (i) outright to the surviving spouse, (ii) to a traditional general power of appointment marital deduction trust, or (iii) to a QTIP trust. The distribution would only be made if the grantor died before the end of the GRAT term, survived by a spouse. Of course, if the GRAT provides that the remainder passes to a QTIP trust, care must be exercised to describe the entire arrangement on the grantor's estate tax return and elect QTIP treatment for such arrangement.

Conclusion

If the above steps are followed, a marital deduction should be allowed in the grantor's estate for the property held in the GRAT (and included in the grantor's estate) if the grantor dies during the term of the GRAT.

In Wealth Transfer Planning's SmartContent Lifetime Estate Planning Module, all of these steps are automatically implemented if the drafter simply clicks "yes" to the question about whether a marital deduction is desired in the event of the grantor's death prior to the end of the GRAT term. An excellent demonstration of this is on the Wealth Transfer Planning website in streaming video on the homepage of www.wealthtransferplanning.com. For those using and modifying their own forms, care should be taken to correctly implement each of these steps.