GRAT Strategies to Minimize Transfer Tax After Tax Reform and Impact of 2026 Sunset Provisions

TUESDAY, JUNE 18, 2019, 1:00-2:50 pm Eastern

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GRATs – Definitions, Requirements, and Considerations

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GRAT – Defined

- G – Grantor
- R - Retained
- A – Annuity
- T – Trust

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GRAT – Defined

- A GRAT (a grantor retained annuity trust) is an irrevocable trust to which the grantor transfers an asset in exchange for the right to receive a fixed amount annuity for a fixed number of fiscal years (the "Annuity Period").
- When the trust term expires, any GRAT balance remaining is transferred tax-free to a designated remainder beneficiary (*e.g.*, the grantor's issue or a "defective grantor trust" for the benefit of the issue).
- If a grantor makes a gift of property in trust to a member of the grantor's family while retaining an interest in such property, the taxable gift generally equals the fair market value of the gifted property without reduction for the fair market value of the retained interest.
- However, I.R.C. Section 2702 provides that for a gift of the remainder of a GRAT in which the grantor retains a "qualified interest", defined to include a guaranteed annuity, the taxable gift will be reduced by the present value of the qualified interest, as determined pursuant to a statutory rate determined under I.R.C. Section 7520(a)(2) (the "Statutory Rate").

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GRAT – Requirements

- Statutory Rate requires an actuarial valuation under prescribed tables using an interest rate equal to 120 percent of the Federal midterm rate in effect for the month of the valuation.
- By establishing the size of the guaranteed annuity and the annuity period at the outset of the GRAT, Grantor can construct so that the present value of the grantor's retained interest approximately equals the value of the property placed in the GRAT, resulting in a "zeroed out" GRAT.
- The annuity payments can be expressed either as a **fixed number** or **a fixed fraction or percentage of the initial fair market value of the property put into** the GRAT. Treas. Reg. Sec. 25.2702-3(b)(1(ii).
- Thus, a GRAT could be structured, where there is no, or a relatively modest, taxable gift.
- A GRAT will not succeed unless the asset that is held by the GRAT increases substantially in value.

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GRAT – Requirements

- An irrevocable trust must be established by creating new, irrevocable trust, or converting revocable trust to an irrevocable trust.
- The trust must provide the Grantor retains the right to the income stream for the term of the trust (the Annuity).
- It is OK to specify payment of the *GREATER* of an annuity amount or a unitrust payment.

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GRAT – Requirements

- The annuity payments can **increase** to up to 120% of the previous year's annuity payment.
- Grantor is making a current gift to the remaindermen of the right to the trust's (the GRAT's) assets.
- ***IF*** the Grantor survives the GRAT term of years, Grantor may realize substantial tax and transfer cost reductions.

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GRATs & Gift Taxes

- **Gift tax consequences of a GRAT. The value of the taxable gift on creation is a function of several factors:**
  - The **value of the underlying property** transferred to the GRAT
  - The **annuity amount**
  - The GRAT **term**
  - The IRC Sec. **7520 rate**
  - The **frequency of payment** of annuity
  - The **time that the annuity amount is paid** (beginning v. end of period)
  - **Age** of grantor or grantor's spouse

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GRAT – Advantages

- Valuation advantages – annuity automatically adjusts on asset revaluation
- Grantor may pay for income taxes associated with GRAT gift tax-free
- Grantor may substitute assets of the GRAT income tax-free
- Synergy with other techniques
- Comparatively low hurdle rate
- High leverage
- Non-recourse risk to remaindermen
- Can pass appreciation while **retaining** a cash stream
- Can take **advantage** of IRC Sec. 7520 interest rate blips relative to current market rates

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GRAT – Advantages

$Permits **leverage** in calculation of gift tax

$Ability to "zero out" GRAT by making the annuity payment the trust made to a client as the grantor creating the trust equal (or almost equal) to the value of assets gifted to the trust

$Great for working with **gifts of partnership/LLC interests** to leverage the applicable exemption amount through the additional use of valuation discounts

$Expressly **sanctioned** in the Internal Revenue Code

$S corporation stock **can** be placed in a GRAT because it is a grantor trust for income tax purposes since the grantor usually will be entitled to all of the trust income. IRC Sec. 677

$Client can be trustee

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GRATs – Suitable Assets

- **Appreciation Potential.** Property that will appreciate in value, and the more the better. The benchmark to consider is the IRC Sec. 7520 rate, or so-called "hurdle rate."
- If the property produces combined income and appreciation in **excess** of the IRC Sec. 7520 rate, the **balance** will inure to the remainder beneficiaries **free of transfer tax**.
- Conversely, if the property transferred to the GRAT **loses** value, as in *Walton*, there may well end up in a **deficit**, meaning zero.

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GRATs – Suitable Assets

- **Cash Flow Is Also Essential.** It is **imperative** to analyze the potential cash flow that can be generated by the assets to be placed in the GRAT for several reasons.

  - **First**, it is **essential** to be able to set the appropriate annuity amount so that there will be some appreciation to pass on.

  - **Second**, IRS has **invalidated** some GRATs in which it seemed very obvious that the assets were insufficient to throw off enough cash flow to satisfy the annuity amount, although this has **not** deterred aggressive estate planners from setting up short term GRAT's with very large payouts.

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GRATs – Suitable Assets

- **Third**, if the assets are expected to **appreciate**, and if cash flow is **insufficient**, then the GRAT trustee will be forced to redistribute GRAT assets back to the settlor, which could erode a substantial amount of the benefit.

- Good practice to **run multiple cash flow scenarios** using a "**best case**"-"**worst case**" scenario in order to identify the tension corridors.

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GRAT – When Indicated?

- Single individual whose estate will likely face substantial estate tax.
- Widowed individual can use a GRAT as a marital deduction trust substitute.
- Married couple with an estate in excess of the combined applicable exemption amount.
- The larger and more rapidly appreciating these estate are, the better the result.

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GRAT – When Indicated?

- Grantor has income producing property spread among several states and desires to streamline and simplify probate.
- In the example above, the GRAT would transfer ownership in a manner that would avoid an ancillary administration.
- A GRAT can protect against a will contest if the Grantor survives the GRAT term.

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GRAT – When Indicated?

- GRAT can serve as an alternative to a recapitalization for an estate freeze (can also be used in conjunction with a recapitalization).
- Has added advantage of gift tax leverage and possible estate tax savings.
- If client is young, even better, because it will result in a lower present value for gift tax purposes, which preserves more of the grantor's exemption for later use.

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GRAT – Considerations

- **Risk** of GRAT **failure** to be tax qualified as gift of whole value of asset placed in GRAT. In other words, if the interest retained is not a "qualified interest" (as defined in IRC Sec. 2702(b)), then the value of the retained interest is **zero.**
- **Limited payout flexibility**, especially when compared to an installment note, which may be tailored to a particular situation with unequal payments of principal and interest.

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GRAT – Considerations

- The greater the length of the term, the greater the value of the retained interest and the lower the value of the remainder interest (the lower the taxable gift to the remainder beneficiaries).

- Establish the value of the assets being contributed to the GRAT by using on or more *qualified* appraisers. Appraisal should be done shortly before assets are transferred to the GRAT.

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GRAT – Considerations

- *Badgley vs. United States, USDC, N.D. Calif;* 4:17-cv-00877 - currently on appeal to the 9th Circuit
- Grantor created GRAT and funded w/ one-half p'ship interest
- Distributions were paid to a bank account in the name of the GRAT, which account was controlled by grantor. Grantor then transferred money from the GRAT bank account to her personal account.
- Grantor's involvement w/p'ship stayed substantially the same after contribution of p'ship interest to GRAT
  - INCLUSION UNDER 2036:
- because Grantor reserved a right to annual annuity payments from the GRAT, which she created with her one-half share in p'ship
- possessed and enjoyed the property because she retained "other interests and powers" in the p'ship including her control over and personal benefit from p'ship activities

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GRAT – Considerations

$Expense of **set up, including valuation** costs can be significant.

$Mortality risk, *i.e.*, risk that the settlor **will not survive the GRAT term**, leading to some estate tax inclusion risk

$Property **must** generate enough positive cash flow to pay the annuity amount, **or** the underlying property has to be **sold** (capital gain to grantor) **or given back** to the grantor (which defeats estate planning purpose), and not many assets do this. Cannot be promissory notes

$Asset must grow at a rate faster than the IRC Sec. 7520 rate, or so-called "hurdle rate," in order for more wealth to pass onto the lower generation

$Despite previously asserting includability under IRC Sec. 2039, IRS now says that the **proper** inclusion section is IRC Sec. 2036

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GRAT – Considerations

- **Inability to "zero out"** (so said IRS. See, e.g., PLR 9239015; Treas. Reg. Sec. 25.2702-3(e), Example 5). However, the Tax Court did **not** agree, and it invalidated that regulation. *Walton v. Comr.*, 115 T.C. 589 (2000). IRS did not appeal *Walton* and has since **acquiesced**. Notice 2003-72.
- Bernie Sander's proposed *For the 99.8 Percent Act* would **eliminate** the right to zero out GRATs by requiring a minimum gift amount and would impose a **ten year minimum term** on the GRAT to eliminate the practice of "rolling GRATs" which would also increase substantially the risk the GRAT would fail (Grantor would die during the term of the GRAT). Could make GRATs impractical for very wealthy taxpayers that have traditionally used GRATs when they no longer had gift tax exemption remaining. DO NOT DISMISS THIS PROPOSAL. This same reformation of the GRAT rules was also in President Obama's "Greenbook!"
- **Cannot** safely use a GRAT for gifts to grandchildren for GST Tax purposes because of ETIP as you cannot allocate GST exemption until the GRAT term expires

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GRATs – Considerations

- **Factors to consider in GRAT structuring**
  - It is imperative to consider a client's remaining life expectancy in structuring the GRAT term.
  - All other things being equal, the **shorter the GRAT term** is:
  - (1) the **larger the taxable gift** will be;
  - (2) the **risk of the client dying** during the GRAT term is **smaller**; and
  - (3) the **likelihood and degree of appreciation** in the value of GRAT assets is **lower**. Conversely, the **longer a GRAT term** is, (1) the **smaller the taxable gift** on GRAT creation will be, (2) the **risk of the client dying** during the GRAT term is **greater** and (3) the **likelihood of appreciation** in the value of GRAT assets is **higher**

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GRATs – Considerations

- Conversely, the **longer a GRAT term** is:
- (1) the **smaller the taxable gift** on GRAT creation will be;
- (2) the **risk of the client dying** during the GRAT term is **greater;** and
- (3) the **likelihood of appreciation** in the value of GRAT assets is **higher.**

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GRATs – Considerations

- For example, IRS Table 2000CM tells us that a 65 year old has a remaining life expectancy of 17.7 years. Therefore, the estate planner probably **should not** suggest a 20 year GRAT term for a 65 year old. But **how long** should that the GRAT term be?
- The answer to this question **cannot** be, and **should not be** given, with absolute certainty. However, the estate planner should make some **inquiry as to mortality age patterns in the client's family**. Then, the estate planner can also "**play the percentages**"

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GRAT – Considerations

- Pay Attention to Valuation - Paying the grantor with hard to value assets may disqualify grantor's retained interest from being a qualified interest, if the assets are valued improperly.
- Only One Contribution - The contribution of assets to the GRAT must be made at the exact point of the creation of the GRAT. Consider a provision prohibiting any additional contributions to the GRAT. IF any additional contribution is made, a new GRAT must be created specifically to hold that contribution. Also could make the trust revocable when trust is created, but amend to become irrevocable once all assignments to trust have been completed.
- The retained annuity interest is valued using the valuation principles under IRC Section 7520.
- The GRAT may not satisfy a client's stewardship goals because the investments of the GRAT may have been too successful, so too much is transferred to remainder beneficiaries.

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GRAT – Considerations

- The GST tax exemption may be difficult to leverage through the use of a GRAT.
- A GRAT will not be successful in transferring assets if the grantor does not survive until the end of the term of the GRAT.
- Avoid Payment Problems – Draft GRAT so annuity amount is deemed paid on a timely basis. Include a provision making the amount of the annuity payment not subject to the trust so that if a portion remains in the hands of the trustee after the annuity payment date, the trustee holds such property only as a nominee or agent for the grantor.

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GRAT – Considerations

CONCERN: THE GRAT WORKS TOO WELL AND TRANFERS TOO MUCH

Limit the amount that is received by the GRAT remaindermen by:

Capping amount left in the trust for the remaindermen at the end of the GRAT term.

If value of assets exceeds the cap, excess is returned to grantor (and therefore included in Grantor's estate for FET).

Name spouse as a discretionary beneficiary and give spouse a special power of appointment.

Grantor Retained Annuity Trusts (GRATs)

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OVERVIEW

- GRAT Risks

- How do GRATS compare to other estate planning techniques?

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Overview of GRAT Risks

- **Mortality Risk**
- **Market Risks**
- **Inflexibility**
- **GST Issues**

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Mortality Risk

- If the grantor dies prior to the expiration of the initial term of the GRAT, a portion or all of the assets comprising the GRAT will be included in the grantor's gross estate for federal and state estate tax purposes.
- The typical term for a GRAT is 2 to 5 years.
- The remaindermen of the trust can be children, or preferably, a trust for the client's spouse and children.

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Mortality Risk Example

- *On January 1, 2018, Client A (grantor) transfers $100,000 to a GRAT for the benefit of his or her spouse and children. The terms of the trust state Client A will receive an annuity of $12,000 per year for a term of 5 years. The annuity is payable in 12 equal installments at the end of each month. Client a dies prior to the expiration of the 5 year term. On the date of Client A's death the value of the trust assets is $300,000. Assume the § 7520 rate is 6%. How much is included in Client A's gross estate?*

- *Answer: $205,440.*
- *Annual annuity (adjusted for monthly payment) / § 7520 rate = amount included under § 2036. Table K adjustment factor = 1.0272.*
- *$12,000 x 1.0272 / .06 = $205,440.*

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Market Risk

- The GRAT must be funded with assets that will hopefully appreciate in value during the lifetime of the GRAT.

- If the rate of return does not exceed or falls below the § 7520 rate (June 2019 rate is 2.8%), the GRAT will not serve as an effective method for transferring wealth. To the extent the rate of return exceeds the § 7520 rate, the GRAT will serve as a more advantageous mechanism for transferring wealth as opposed to other methods.

- *Example: Client A transfers 100 shares of Company X to a 2 year GRAT for the benefit of his or her spouse and children. The terms of the trust stipulate that Client A will receive an annuity of a fixed percentage of the stock value. Company X is hit with a large lawsuit in year 1 and the stock plummets for a prolonged period of time. Is the GRAT an advantageous method in this scenario?*

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Market Risk (cont'd)

Asset Substitution

- A grantor may reacquire trust assets by substituting property of equivalent value without incurring the imposition of any income tax. IRC § 1014(a).

- The grantor may exercise the "swap power" by exchanging assets of equal value for assets within the GRAT. The exchange of assets is not deemed to be a taxable event for income tax purposes. However, there may be transfer tax issues with respect to the transfer of New York City real estate.

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Inflexibility

Annuity Payments / 120%

- The trust is required to pay an annuity amount at least once a year to (or for the benefit of) the annuitant. The requirement of annual or more frequent payments (depending on the terms of the trust) can be difficult is the asset(s) transferred to the trust are not liquid.

- The annuity amount must be based on a fixed fraction or percentage of the initial FMV of the property transferred to the trust.

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Example (Fixed Annuity Payments)

- *Client A transfers $1,000,000 to a 3 year GRAT for the benefit of his or her spouse and children. The June 2019 § 7520 rate is 2.80%. The annual income earned by the Trust is 5%.*

Year	Beginning Principal	5% Annual Income	Required Payments	Remainder
1	$1,000,000.00	$50,000.00	$352,174.60	$697,825.40
2	$697,825.40	$34,891.27	$352,174.60	$380,542.07
3	$380,542.07	$19,027.10	$352,174.60	$47,394.57
Summary	**$1,000,000.00**	**$103,918.37**	**$1,056,523.80**	**$47,394.57**

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Example (Varied Annuity / 120% Payments)

- *Client A transfers $1,000,000 to a 3 year GRAT for the benefit of his or her spouse and children. The June 2019 § 7520 rate is 2.80%. The annual income earned by the Trust is 5%.*

Year	Beginning Principal	5% Annual Income	Required Payments	Remainder
1	$1,000,000.00	$50,000.00	$291,222.50	$758,777.50
2	$758,777.50	$37,938.88	$349,467.00	$447,249.38
3	$447,249.38	$22,362.47	$419,360.40	$50,251.45
Summary	**$1,000,000.00**	**$110,301.35**	**$1,060,049.90**	**$50,251.45**

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Inflexibility (cont'd)

Appraisals

- The need for appraisals depends on what assets are being used to fund the trust (e.g. stock in a privately held corporation, member interests in a limited liability company, real property, cash, etc.).

- If the yearly annuity is paid in-kind (e.g. real estate or art) with difficult to value assets, such assets will need to be annually appraised in order to determine that the annuity requirement is met in good faith.

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GST Issues

- A GRAT is not an effective method for making gifts to grandchildren because the retained term leads to an estate tax inclusion period (ETIP). Any allocation of the GST exemption is not effective until the termination of the annuity term. IRC § 2642(f).

- Some practitioners recommend that the remainder beneficiaries of a GRAT gift or sell their remainder interest to avoid the disadvantageous GST tax result. Once the gift or sale is made, the grantor would allocate sufficient GST exemption to cover the value of the remainder interest, so that the appreciation coming out of trust would be completely GST tax-exempt.

How do GRATs Compare to Other Estate Planning Techniques?

- **Outright Gift**
- **Loan**
- **Sale to a Grantor Trust**

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Outright Gift

- A client may gift property to his or her children.

- Benefits of an outright gift:
  - Grantor need not outlive the trust term in order to achieve the estate planning objectives.
  - Simpler, less expensive.

- Negatives:
  - Possible gift tax.
  - Loss of control (e.g. if the asset being transferred is a closely held corporation).

Loan

- A client may loan funds to his or her children or to a GST Trust. The interest required to be charged by the client/lender is the applicable federal rate (AFR). Currently, interest rates are very low (June 2019 mid-term AFR is 2.38%). The § 7520 rate, by comparison, is 120% of the mid-term rate, which is higher.

- Benefits of a loan:
  - No survivorship requirement for tax effectiveness.
  - Simpler, less expensive (but still carries an administrative burden (e.g. administration of interest payments)).

- Negatives:
  - The borrower bears the risk and the reward with respect to the investment acquired with the loan proceeds. If the investment declines, the borrower is liable for repayment under the note.

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Sale to a Grantor Trust

- A client may sell property to a “grantor trust” in exchange for a promissory note. The sale is disregarded for income tax purposes, so no gain or loss is recognized. Because the sale is recognized for gift and estate tax purposes, the property transferred to the trust is excluded from the grantor’s estate. Consequently, the future appreciation and income, to the extent exceeding the interest on the note will inure to the benefit of the beneficiaries of the trust free of any transfer tax.

Sale to a Grantor Trust (cont'd)

- Benefits of a Sale to a Grantor Trust:
  - No survivorship requirement for tax effectiveness.
  - Assuming interest rates are low, the lower rate on the note (usually mid-term AFR) will lead to less funds being returned to the grantor and, thus, available for the beneficiaries.
  - The promissory note does not cause an ETIP.
  - The terms of the note are flexible. The note may call for payments of interest only, with a balloon payment of principal at maturity (subject, of course, to the agreed terms of the note). The client may utilize proper discounts.
  - Generation-skipping depending on the jurisdiction.

- Negatives:
  - Interest due under the note must be paid annually or may be disregarded (cash flow).
  - While the note is outstanding the grantor is liable for all income taxes generated by the trust.
  - The possibility that the assets will decrease in value from the original sale price.

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When Might You Choose GRATs over a Sale to a Grantor Trust?

- Generation-skipping is not a strong concern of the client.
- The client has a single, easily valued asset (such as an IPO).
- IRS audit.
- Valuation risk.
- Remainder Trust for the benefit of a client's spouse and children.

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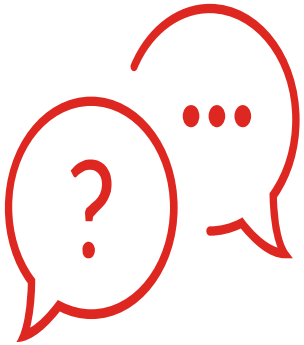

Q&A

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GRATs During & After GRAT Term - A Practicing CPAs Viewpoint On Behalf of Strafford Publishing

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FILING OF A GIFT TAX RETURN

- As to the taxable gift, the Form 709 presentation and supporting documentation
- With open Estate Tax Inclusion Period (ETIP) prevents effective allocation of Lifetime GST Exemption, Form 709 methodology

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GRAT TERM ISSUES

- If GRAT very successful or very much not, locking in and restarting – swap powers, insertion of note, etc.
- What happened with buying out a GRAT Remainder Interest?
- Estate taxation inclusion if the settlor dies during the GRAT term - §2036, not §2039, so is purchase of life insurance appropriate?
- Zeroed-out GRATs and marital deduction issues
- Applications with states that do and do not allow self-settled trusts
- Keep in mind, if residence sold and not replaced from a QPRT/House GRIT, the Trust becomes a GRAT

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UNWINDING A GRAT

- Payment to individual(s), complex or grantor trust – what are the implications?
- If to an individual who is deemed inappropriate, what can a trustee do before the GRAT term ends?
- If continuing in a trust, is it appropriate to change trustee?
- Is basis an issue, and if so, what are some planning options?
- Client representation politics if settlor retained direct or indirect interest in underlying asset

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- Business succession planning
- Traditional and private placement life insurance (PPLI)
- Chapter 14 of the Internal Revenue Code and particularly its impact on carried interest planning for private Equity and hedge fund principals
- Nonresident alien investments in United States real estate
- Fiduciary income tax for domestic and international maters including throwback and attribution to beneficiary rules
- Generation-skipping transfer (GST) tax
- Asset protection planning.

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- Stafford Publishing, Estate Planning Advisory Board
- Goldberg Study Group
- New York State Society of Certified Public Accountants (Annual Estate Administration Conference, Former Chair, Annual Estate Planning Conference, Former Chair, Income of Estates and Trusts Committee, Former Chair, Estate Planning Committee, Former Chair)
- Society of Trusts & Estate Practitioners, STEP USA, Former Treasurer
- The Estate Planning Council of Rockland County, Former President