The ETIP Rule and its "Remote Possibility" Exception: The Authorities

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I. The GST Regs

A. General Definition of the ETIP. Treas. Reg. Section 26.2632-1(c)(2)(i) sets forth the following the general definition of the ETIP:

> (2) ESTATE TAX INCLUSION PERIOD DEFINED -- (i) IN GENERAL. An ETIP is the period during which, should death occur, the value of transferred property would be includible (other than by reason of section 2035) in the gross estate of –
>
> (A) The transferor; or
>
> (B) The spouse of the transferor.

B. Important Exceptions to the General Definition. Treas. Reg. Section 26.2632-1(c)(2)(ii)(A) and (B) sets forth the first two of three important exceptions to the general definition, as follows:

> (ii) EXCEPTIONS -- (A) For purposes of paragraph (c)(2) of this section, the value of transferred property is not considered as being subject to inclusion in the gross estate of the transferor or the spouse of the transferor if the possibility that the property will be included is so remote as to be negligible. A possibility is so remote as to be negligible if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the property will be included in the gross estate.
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> (B) For purposes of paragraph (c)(2) of this section, the value of transferred property is not considered as being subject to inclusion in the gross estate of the spouse of the transferor if the spouse possesses with respect to any transfer to the trust, a right to withdraw no more than the greater of \$5,000 or 5 percent of the trust corpus and such withdrawal right terminates no later than 60 days after the transfer to the trust.

II. Short-term GRATs and the Remote Possibility Exception

A. In General. Most GRATs are structured so that if the grantor survives the term of the GRAT no portion of the property transferred to it (and remaining in the GRAT at the end of the term) will be included in the grantor's gross estate. Accordingly, it is arguable that if there is less than a 5% probability that the grantor will die before the end of the trust term, there is no ETIP applicable to the transfer. The IRS could take the position that the ETIP rule applies because a portion of the transferred property will be returned to the grantor in the form of annuity payments which are likely to be included in her gross estate under §2031 of the Code. The better view would ignore this possibility because the right to receive the annuity payments was retained and is not properly considered part of the transferred property.

B. Some Sample Probabilities. According to Larry Katzenstein's Tiger Tables:

1. **Two-year GRATs.** There is less than a 5% probability that a 68 year old will die before reaching age 70, but there is more than a 5% probability that a 69 year old will die before reaching age 71. Therefore, if the remote possibility exception to the ETIP rule applies, a two-year GRAT created by a grantor who is 68 or younger at the time of creation (and whose health is consistent with the use of the tables) is not subject to an ETIP.

2. **Three-year GRATs.** There is less than a 5% probability that a 63 year old will die before reaching age 66, but there is more than a 5% probability that a 64 year old will die before reaching age 67. Therefore, if the remote possibility exception to the ETIP rule applies, a three-year GRAT created by a grantor who is 63 or younger at the time of creation (and whose health is consistent with the use of the tables) is not subject to an ETIP.

C. Allocation of GST Exemption to a GRAT Not Subject to an ETIP

1. **The Basic Rules.** In order for a trust to have a zero inclusion ratio, the amount of GST exemption allocated must equal the denominator of the applicable fraction as defined in Code Sec. 2642(a)(2)(B), which in the case of a GRAT equals "the value of the property transferred to the trust." Treas. Reg. Sec. 26.2642-2(a)(1) provides that

> For purposes of determining the denominator of the applicable fraction, the value of property transferred during life is its fair market value on the effective date of the allocation of GST exemption. In the case of a timely allocation under section 26.2632-1(b)(2)(ii), the denominator of the applicable fraction is the fair market value of the property as

finally determined for purposes of chapter 12.

2. **The Open Issue.** It is unclear whether the term, "property transferred," refers to the assets transferred to the trust without reduction for the retained interest or whether the use of the word "transferred" necessarily requires a reduction for the value of the interest that was retained (i.e., <u>not</u> transferred). Some commentators addressed this issue before the passage of the ETIP rule in 1988 as part of TAMRA but there was no consensus concerning the proper treatment, with at least some commentators indicating that the amount of GST exemption that would need to be allocated to result in a zero inclusion ratio is uncertain. TAMRA's retroactive creation of the ETIP rule appeared to put this issue to rest -- but perhaps it didn't.

D. **What does this Mean?**

1. **The Good News.** It may be possible to allocate GST exemption to certain short term GRATs and lock in the current value of the property involved for GST purposes. However, because of the uncertainty of whether the allocation must be of the full amount transferred or of the gift tax value, it may be desirable to make a manual allocation based on the gift tax value and not allowing the automatic rules to apply. This may require an election out of the automatic rules. Consider using the following formula:

> The donor allocates to the property she transferred to the Donor 2005 GRAT an amount of GST exemption equal to the value, as finally determined for federal gift tax purposes, of the amount of her transfer to such that constituted a taxable gift.

2. **The Bad News.** If the ETIP rule does not apply to GRATs under the circumstances described above, care must be taken to avoid the automatic allocation rules and formula allocations based on the "amount necessary to produce a zero inclusion ratio," either of which could otherwise result in an inadvertent use of a transferor's entire GST exemption. To eliminate this risk, it is advisable to make an election out of the automatic allocation rule for all transfers to GRATs and then, if an allocation is to be made, to use a formula like the one in subparagraph 1 above.

III. <u>**Spousal Withdrawal Rights and the Possibility of Inclusion**</u>

A. **In General.** If a transferor gives her spouse the right to withdraw more than the greater of $5,000 or 5 percent of the trust corpus or if the withdawal right is exercisable for a period longer than 60 days (from the date of the transfer), the exception to the ETIP rule described in Treas. Reg. Section 26.2632-1(c)(2)(ii)(B) will not apply. The existence of the withdrawal right will create an ETIP that will not lapse until the lapse of the entire withdrawal right.

B. **Some Sample Probabilities.** Suppose, a transferor gives her husband the right to withdraw $10,000 worth of property for 60 days after the transfer. In order to prevent the lapse from being treated as a taxable gift, after the 60 day period, the husband will continue to have the right to withdraw $5,000 until the first day of the next calendar year when the right to withdraw the second $5,000 will lapse. According to Larry Katzenstein's Tiger Tables, there is less than a 5% probability that a 77 year old will die before reaching age 78, but there is more than a 5% probability that a 78 year old will die before reaching age 79. Therefore, if the remote possibility exception to the ETIP rule applies, a withdrawal right held by a spouse who is age 77 or younger and that is exercisable for a period not longer than one year will not cause the ETIP rule to apply even if the amount subject to the withdrawal right exceeds greater of $5,000 or 5 percent of the trust corpus or if the withdrawal right is exercisable for a period longer than 60 days.