

Planning Ideas—GRATs Remain in Season

Since 1990 the value of property transferred to certain grantor trusts has been determined under what is known as Chapter 14 of the Internal Revenue Code. Under the general rule, when a grantor makes a transfer in trust to or for the benefit of a family member and retains an interest in the trust, the retained interest is valued at zero, regardless of the actual value of the retained interest. Consequently, the transfer tax benefits are comparable to an outright gift. That is, the transferred property along with post-transfer appreciation is shifted to the remainder person, but the value of the gift is the full fair market value of the property transferred.

One important exception to the **zero-value** rule is a Grantor Retained Annuity Trust (GRAT). A GRAT is a trust under which the grantor retains an interest in the transferred property. The grantor's retained interest must be a fixed annuity interest as opposed to the right to receive mere income from the trust. The annuity must be an irrevocable right to receive a fixed amount payable to, or for the benefit of, the grantor or his or her transferee, each year for the term of the trust. The fixed amount must be payable at least annually and must be stated as a dollar amount or as a percentage of the initial fair market value of the transferred property. Additional contributions to the GRAT are prohibited along with distributions to or for the benefit of anyone other than the holder of the retained interest during the initial term. The term of the annuity must be specified and fixed under the terms of the trust. Acceptable terms include the life of the holder of the retained interest, a specified period of years, or a term of years that is the shorter of the life of the term holder or a term of years.

Gift Tax Considerations

If the trust qualifies as a GRAT, the value of the retained interest is determined under traditional methods. The typical approach is to consult the appropriate IRS valuation tables based on the Applicable Federal Rate (AFR) to determine the annuity factor and multiply the factor by the amount of the annual payment in order to arrive at the value of the retained interest. The amount of the gift is the difference between the value of the transferred property and the retained interest. Because the gift is of a future rather than a present interest, the gift does not qualify for the annual gift tax exclusion.

Example

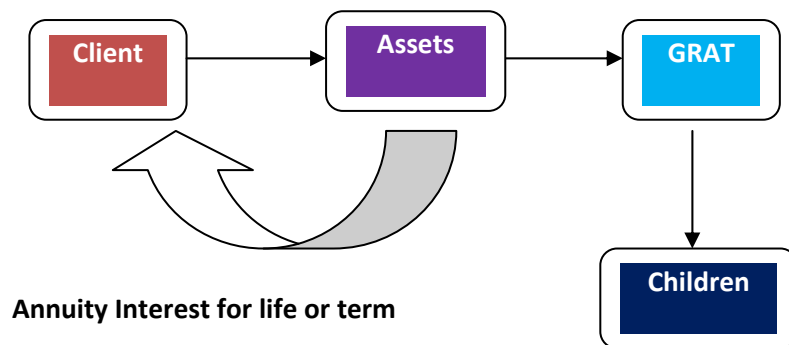
Assume Lucy transfers property currently valued at \$5 million to a trust for the benefit for her son, Ricky. She retains a payment of \$1,175,000 per year for 5 years. The AFR is 6 percent.

The value of Lucy's interest (\$4,949,531) is determined by reference to government tables. When this amount is subtracted from \$5 million, the balance is \$50,469. This is the value of the remainder interest, the gift. Assuming appreciation of 15% annually, the assets remaining in the GRAT at the end of the 5 year term equal \$2,134,488 and are distributable to Ricky free of gift or estate tax. Thus, Lucy has transferred over \$2,000,000 to Ricky with a taxable gift of only \$50,473.

Note that, when interest rates are low, GRATs are an even better deal. If the AFR dropped to just 5.8 percent, the value of the remainder interest would be only \$23,429.

The figure below graphically illustrates the operation of a GRAT.

Figure 1



Zeroed-Out GRATS

Another interesting aspect of GRATs is that, theoretically, the gift tax value may be driven to zero. This is accomplished by setting the annual payment at an amount that, based on the AFR, depletes the fund by the end of the GRAT term.

For example, assume Lucy wishes to incur no gift with respect to the transfer to Ricky. Assuming again a 5 year term and a 6% AFR, an annual payment of just \$12,000 per year

(\$1,187,000) results in a gift tax value of zero. If the assets appreciate at 15 percent, the amount passing to Ricky is \$2,053,579. For a gift tax cost of zero, over \$2,000,000 is transferred out of Lucy's estate.

Note that these examples are for illustrative purposes only and assume that the GRAT is for a fixed term and does not contain a reversionary interest in the event the grantor dies before the end of the term. Inclusion of a reversionary is likely to have the effect of increasing the gift tax value for the reason that the reversionary interest is valued at zero under the Chapter 14 rules.

Income Tax Considerations

GRATs are grantor trusts for income tax purposes. Consequently, trust income is taxable to the grantor. On the other hand:

- No gain or loss is recognized on the creation of the GRAT; and
- The payment of the annual annuity by the GRAT to the grantor is ignored for income tax purposes.

Thus, the distribution of appreciated property in satisfaction of the annuity does not result in recognition of gain by the grantor.

Estate Tax Considerations

The federal estate tax has been repealed for 2010, however, the estate tax is set to reappear in 2011. Unless Congress acts to the contrary, the maximum rate will increase to 55 percent and the exemption will decrease to \$1 million. Furthermore, some commentators fear that the estate tax will be retroactively reinstated for the year 2010. Given this state of affairs, estate taxes must be considered when planning for GRATs.

Although a GRAT is an exception to the zero-value rule, thus allowing an actual value to be applied to the retained interest for gift tax purposes, the trust assets are included in the gross estate if the grantor dies during the term of the trust. Of course, if the grantor survives the value of the term, the value of the property along with any post-transfer appreciation escapes taxation in the grantor's generation.

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The value of the trust included in the grantor's estate has been the subject of much debate. Final regulations issued in 2009 take the position that IRC Section 2036 applies. According to the regulations, the value included in the grantor's estate is the amount of the annual annuity payment divided by the AFR. For example, if the annual payment is \$100,000 and the AFR at the time of death is 7%, the amount included in the estate is \$1,428,571 (\$100,000 divided by .07). This is the amount of capital required to generate sufficient income at the AFR to pay the required annuity.

Given the estate inclusion risk associated with GRATs, it is common for planners to include a reversionary interest in the trust, making trust assets payable to the grantor's estate if the grantor predeceases the trust term. Such a provision increases the gift tax value of the transferred interest, however, it assures that the estate possesses adequate assets with which to pay estate taxes on the included value.

Generation-Skipping-Transfer Tax Considerations

Like the federal estate tax, the generation-skipping-transfer (GST) tax enjoys a one-year repeal for 2010. However, assuming reinstatement of the tax, a trust that distributes to grandchildren or other younger-generation beneficiaries may trigger the GST tax. Unfortunately, the grantor cannot allocate GST exemption to property transferred during an estate tax inclusion period (ETIP), unless the actuarial chance of the Grantor not surviving the ETIP period is less than five percent. The ETIP is the period of time after the transfer in trust during which the value of the trust property would be includable in the grantor's gross estate. Practically speaking, this means that in many instances GST exemption cannot be allocated until expiration of the trust term at which time the trust assets are likely to have appreciated. Allocating GST exemption at such time and under such circumstances fails to leverage the GST exemption. Consequently, most planners avoid using GRATs to transfer assets to grandchildren or other younger-generation beneficiaries.

Proposed Legislation

On March 24, 2010, the House passed the Small Business and Infrastructure Jobs Tax Act of 2010, which contains a provision instituting a ten-year minimum term for GRATs and a requirement that the remainder interest for GRATs be greater than zero. As of the date of this writing, the bill remains stalled in the Senate.

Bottom Line

Given low interest rates and pending legislation, 2010 is an excellent time for creating and transferring property utilizing GRATs. Assets with currently depressed values or assets (such as closely held business interests) that may be subject to a discount are especially attractive for use in funding GRATs.

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