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GRATs: TIME IS RUNNING OUT

Grantor retained annuity trusts (GRATs) create a current opportunity to transfer appreciating assets free of transfer taxes. But act soon, as pending changes to the law will increase the risk of those assets being included in the grantor's estate.

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OPPORTUNITY TO ELIMINATE TRANSFER TAXES ON GIFTS

By transferring appreciating assets to a GRAT, individuals may transfer those assets free of gift or estate taxes, provided the grantor outlives the GRAT annuity term and the transferred assets appreciate at a rate in excess of the monthly federal interest rate referenced by the § 7520 rate. Although the § 7520 rate continues to fall to unprecedented lows (2.0 percent in November 2010), pending legislation would increase the risk of inclusion of the assets owned by the GRAT in the grantor's estate by establishing a minimum ten-year annuity term for all GRATs. Currently, annuity terms of as low as two years have been blessed by the courts and the Internal Revenue Service.

HOW DOES A GRAT WORK?

A GRAT is a trust in which the grantor retains the right to receive annuity payments in an amount equal to a percentage of the value of the assets transferred to the GRAT, with the remainder interest in the assets passing to the named beneficiaries (generally to or in trust for the grantor's children). Since the Internal Revenue Code provides that the gift tax value of property transferred to a GRAT is determined by reducing the value of the property transferred by any interest retained by the grantor, the value of the right to receive annuity payments from the trust reduces the value of the gifted remainder interest. By "zeroing out" the value of the gifted remainder by the value of the retained annuity, the gift tax on the remainder may be eliminated in its entirety.

KEY TAKEAWAYS

- Internal Revenue Code Section 7520 ("the § 7520 rate") rates are at all-time lows (2.0 percent in November 2010), increasing the pool of appreciating assets that serve as good candidates for GRAT transfers.
- Pending legislation would require a minimum ten-year annuity term for GRATs, increasing the risk of inclusion of GRAT assets in the grantor's estate.
- Time to maximize the benefit of using GRATs is running out, as pending legislation would increase the risk of including appreciating assets in the grantor's estate.

EXAMPLE

The following example illustrates the benefit when stock transferred to a two-year GRAT doubles in value each year for two years:

- On January 1, 2011 (assuming no change to the law before that date), a GRAT is funded with 10,000 shares of XYZ nonvoting stock, valued at $500 per share at the time of transfer (total value of property transferred to the GRAT = $5,000,000).

- Assuming that the GRAT is required to pay the grantor an annuity for two years, each annuity payment is an amount equal to 52 percent of the value of the property transferred to the GRAT ($2,600,000).
- •Assume that on January 1, 2012, the XYZ nonvoting stock is worth $1,000 per share. The 2012 annuity payment due is $2,600,000 and can be paid with 2,600 shares of XYZ stock ($1,000 per share x 2,600 shares = $2,600,000), leaving 7,400 shares of stock in the GRAT.
- Assume that on January 1, 2013, the XYZ nonvoting stock is worth $2,000 per share. The 2013 annuity payment of $2,600,000 can be made with 1,300 shares of XYZ stock ($2,000 per share x 1,300 shares = $2,600,000). At the end of the annuity period, a total of 3,900 shares of XYZ stock have been used to fund the annuity payments, and the GRAT holds the balance of 6,100 shares of XYZ nonvoting stock with a total value (as of January 1, 2013) of $12,200,000.
- Assuming that the grantor survives the two-year annuity term, those 6,100 shares valued at $12,200,000 have been transferred out of the grantor's estate and to the grantor's beneficiaries, without incurring any gift taxes.

WHAT IS A ZEROED-OUT GRAT?

A zeroed-out GRAT is structured to require annuity payments to the grantor equal to 100 percent of the value of the property transferred to the GRAT, plus interest at the § 7520 rate, with both the value of the property and the § 7520 rate determined as of the date of transfer. As a result, the value of the gift of the remainder interest is "zeroed out" by the value of the retained annuity, resulting in a gift-tax-free transfer. The annual payments from the GRAT to the grantor can be made in cash or by in-kind distributions of GRAT assets. If the annuity payments are in kind, the property is revalued at the date of each payment to determine the portion of the property required to make such payments. To the extent that the property transferred to the GRAT appreciates at a rate in excess of the § 7520 rate (as of the date of the original transfer to the GRAT), there will be value remaining in the GRAT assets net of the annuity payments that will pass gift-tax-free to the remainder beneficiaries.

WHAT TYPE OF ASSETS SHOULD BE USED TO FUND A GRAT?

Generally, any asset appreciating at a rate higher than the § 7520 rate can be used, including a diversified equity portfolio. Property expected to increase significantly in value before the first annuity payment comes due would yield the best results from a GRAT, since annuity payments based on a percentage of the original value of the GRAT property can be satisfied with appreciated property, which maximizes the amount of property left in the GRAT for the remainder beneficiaries. Even if the assets used to fund the GRAT fail to perform as expected, there is virtually no downside, since the effect would be that the assets would simply come back to the grantor as annuity payments.

HOW LONG SHOULD THE ANNUITY TERM BE?

Ideally the annuity term should be designed to capture the appreciation expected in the property used to fund the GRAT. However, since in general the death of the grantor during the annuity term will cause all of the GRAT's assets to be brought back into the grantor's taxable estate, you should keep the annuity term as short as possible. Under current law, two years is the shortest annuity term permitted. However, pending legislation would require a minimum ten- year annuity period. To maximize the effectiveness of the GRAT and to reduce the risk of inclusion of the GRAT's assets in the grantor's estate, the GRAT should be formed and funded before the law is amended.

DOES TRANSFERRING APPRECIATED ASSETS TO THE GRAT TRIGGER AN INCOME TAX LIABILITY?

A GRAT will be structured as a "grantor trust" for income tax purposes, at least during the annuity term. A transfer of appreciated property to a grantor trust is not treated as a taxable event, since the grantor is simply transferring property to himself or herself and not to an independent taxable entity. Moreover, depending on how the GRAT is structured, the grantor may continue to pay the GRAT's income taxes without having such benefit treated as a taxable gift to the GRAT's remainder beneficiaries.

SUMMARY

Historically low interest rates, coupled with laws approving short- term GRATs, create an opportunity to transfer appreciating assets free of transfer taxes. If properly structured, and assuming that the property transferred appreciates at a rate in excess of the § 7520 rate at funding and that the grantor survives the annuity term, a GRAT allows the transfer of appreciating assets to the next generation without incurring any gift or estate tax. Because of expected changes to the law, clients who are interested in GRATs should proceed as soon as possible.

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