Fein, Such, Kahn & Shepard, P.C.

COUNSELLORS AT LAW

Basics of GRAT

A grantor retained annuity trust (GRAT) is a useful strategy to shift wealth from one generation to the next with little risk and typically little or no gift tax. A GRAT allows the grantor to retain some income interest for a period of time and then ultimately transfer assets, at a reduced transfer tax cost to children.

A grantor creates a GRAT by transferring assets into an irrevocable trust while retaining the right to receive an annual payment known as an annuity. The retained annuity interest allows for a reduction in the value of the property transferred for gift tax purposes. The retained interest also provides the grantor with a cash flow stream for a period of time.

Assets to Consider for a GRAT

Not all of a client's assets are appropriate for GRAT treatment. A prime consideration is the anticipated appreciation of the asset. In order to be at all successful in a GRAT, the assets must appreciate at a rate greater than a "hurdle rate." The hurdle rate is the IRC section 7520 rate for the month in which the GRAT is created. The 7520 rate is adjusted by the IRS each month. Therefore, any assets that are transferred to a GRAT must have anticipated appreciation in excess of the "hurdle rate."

Another consideration is how is the GRAT going to make annuity payments. A portion of the assets (the annuity payment) needs to be distributed to the grantor on each anniversary of the GRAT. Alternatively, the annuity payments may be made in cash, if cash is available in the GRAT. If the assets in the GRAT are privately held securities and the grantor is going to receive them in kind (a distribution in which the property itself is distributed, not cash), an annual valuation may be necessary.

Term of the GRAT

The grantor is able to select the term of the GRAT, but the term must be at least two years[1]. The grantor's age and health must be considered.

Should the grantor die within the term of the GRAT, several opinions exists as to what portion of the GRAT is includible in the grantor's estate.

One opinion is that all the assets of the trust are includible in the estate which results in the technique being a complete failure. Another opinion is that only the amount of assets necessary to make the remaining annuity payments is includible in the estate.

[1] There is currently a Bill approved by the House of Representatives and Congress placing a minimum term of ten years on GRATS, but same has not passed the Senate at this point.

If the grantor is seventy years old and in poor health, a five-year term is excessive. A more appropriate term may be two years. The key to a successful GRAT is to create a term that maximizes appreciation within the GRAT and terminates as soon as possible after the appreciation. The shorter the term the more likely the grantor will survive the term and not make the GRAT assets subject to estate tax. However, in a low interest rate period (interest rates including the Section 7520 Rate for September, 2010 is 2.4%) using a longer term GRAT may be a proper strategy, since the "hurdle rate" is then locked in at a low rate.

Income Taxation of GRAT

When creating a GRAT, the grantor must understand that he or she will be taxed on all activity within the trust during the term in which it is a GRAT. This is particularly important from a cash flow perspective as the grantor may have an income tax liability from the GRAT that greatly exceeds the annuity payment (the annuity payment has no relevance for income tax purposes). The IRS has ruled that the payment by the grantor of the GRAT's income tax liability is not a gift. Thus, the grantor is able to increase the value of assets passing to his children by paying the GRAT income taxes. Nevertheless, to protect the grantor from a cash flow problem, GRATs should have income tax reimbursement provisions. An income tax reimbursement provision is one in which the grantor is reimbursed by the GRAT for income taxes paid by the grantor on income from the GRAT, at the discretion of the trustee of the GRAT.

Gift Tax Treatment of GRAT

When the grantor creates a GRAT, it is a completed gift and a gift tax return must be filed for this transaction. The amount of the taxable gift is a function of the term of the trust, the annuity amount, the 7520 rate, and the age of the grantor.

It is now possible for you to create a GRAT and zero-out the GRAT for gift tax purposes. A zeroed-out GRAT is one in which the value of the remainder interest (amount passing to your children) is calculated to be zero at the time the GRAT is initially funded. The benefit of the zeroed-out GRAT is that the grantor will not incur any gift tax liability and will not use any of his lifetime federal gift tax exemption.

Example

The following Example #1 illustrates how a GRAT can be successful.

Mr. X is 58 years old and creates a GRAT. The GRAT is for 5 years, is "zeroed-out," and has a level annuity payment. The value of the property is $2,000,000 at the time of transfer with a basis of $200,000 and the 7520 rate for the month in which the GRAT is created is 6%. The annual appreciation on assets contributed is 10%.

Mr. X will need to receive an annuity payment of 23.73943% or $474,788.60 annually. Mr. X will have made a taxable gift of 50 cents.

In years one through four, the GRAT has $200,000 of interest and dividends. Mr. X will need to include the $200,000 on his individual income tax return. The $474,788.60 is not relevant for income tax purposes.

At the end of year five, the GRAT has $322,388.12 of assets remaining. These assets are then distributed, free of transfer tax, to either individual beneficiaries or to another trust.

As a result of the recently decided Walton case, funding the GRAT results in no taxable gift. Example #2 demonstrates that if the assets transferred to the GRAT appreciate significantly, a large amount of value can be transferred to children, or to a remainder trust for the benefit of children and more remote descendants. Additional flexibility can be achieved by including a spouse and charities as eligible beneficiaries of the remainder trust.

Example (all numbers are approximate): Assume a grantor transfers an asset worth $1,000,000 to 2-year zeroed-out GRAT when the IRS prescribed interest rate is 5.8%. The GRAT requires an annuity payment of $500,000 at the end of year 1 and $600,000 at the end of year 2. No taxable gift results from funding this trust.
The possible benefits of creating this GRAT are illustrated on the next page. The calculations are based on hypothetical appreciation rates of 10% - 200%.

Growth Rate	Approx. Amount Returned to Grantor	Approx. Remainder in 2 Years	Approx. Estate Tax Savings
10%	$1,100,000	$80,000	$40,000
30%	$1,100,000	$460,000	$230,000
50%	$1,100,000	$925,000	$462,500
100%	$1,100,000	$2,425,000	$1,212,500
200%	$1,100,000	$6,935,000	$3,467,500

This is a simplified discussion of a complicated topic. More complex planning is required if the Grantor fails to survive the GRAT annuity term. Planning for a possible marital deduction in the case of a zeroed-out GRAT can be particularly complex. There are many other ways to structure GRATs to deal with specific situations. Also, there are certain risk factors, including tax law risks, valuation risks, and the possibility that the grantor might die during the term of the trust, that must be reviewed and analyzed in each individual case.

Circular 230 Disclosure: Internal Revenue Service regulations provide that, for the purpose of avoiding certain penalties under the Internal Revenue Code, taxpayers may rely only on opinions of counsel that meet specific requirements set forth in the regulations, including a requirement that such opinions contain extensive factual and legal discussion and analysis. Any tax advice that may be contained herein does not constitute an opinion that meets the

requirements of the regulations. Any such tax advice therefore cannot be used, and was not intended or written to be used, for the purpose of avoiding any federal tax penalties that the Internal Revenue Service may attempt to impose.