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## Estate Planning: Minimize Your Estate and Taxes Via a GRAT

by Robert M. Russell

The current uncertain political, economic and tax environment has led many people to postpone preparing or updating their estate plans. On Dec. 17, 2010, the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" was signed into law, enacting a sweeping tax package that provides significant estate tax relief, but only for two years. Combined with the current low interest rate environment, the new law creates a limited opportunity for individuals to take advantage of the most favorable wealth transfer laws ever. One estate planning strategy that is extremely effective in an environment of low interest rates and depressed asset values is a Grantor Retained Annuity Trust or "GRAT." A GRAT allows a person to assign the future appreciation of an asset to the next generation with virtually no transfer tax.

How does a GRAT work? An individual wishing to implement a GRAT will create an irrevocable trust (the GRAT) for a specified number of years. The individual (the *grantor*) then transfers certain assets to the GRAT in exchange for a fixed payment stream for a specified term of years (the *term* of the GRAT). During the term of the GRAT, the grantor receives an annual (or more frequent) annuity payment. At the end of the GRAT term, the remaining principal of the GRAT, if any, will be distributed to, or held in further trust for the beneficiaries specified by the grantor.

The transfer of assets to the GRAT by the grantor is deemed to be an irrevocable gift by the grantor to the GRAT beneficiaries. The value of the gift is determined by subtracting the value of the retained annuity payments that will be made to the grantor from the initial fair market value of the assets used to fund the GRAT. The value of the retained annuity payments is determined by regulations established by the Internal Revenue Service (IRS), using the interest rate in the month the asset is transferred to the GRAT (set each month by the IRS), the length of the GRAT, and the dollar amount of the annuity to be paid to the grantor.

If the assets in the GRAT appreciate in value at a rate that is greater than the interest rate set by the IRS, all the excess appreciation escapes estate and gift taxes. The interest rate currently in effect for GRATs is approximately 2 percent.

A grantor is able to minimize the gift attributable to a GRAT by setting the retained annuity payments at an amount that is almost equal to the fair market value of the assets transferred to the GRAT. For example, if a grantor transferred an asset worth $250,000, the grantor is able to set the retained annuity payment value at $249,950, thereby making only a $50 taxable gift to the GRAT. A GRAT that is established where the taxable gift close to or set at zero known as a "zeroed-out GRAT" (that is, the taxable gift is close to zero). This is done to avoid paying gift tax.

There should be no gift tax consequences at the termination of a GRAT. The gift is complete upon the funding of the GRAT. Refer to the example above. Let's say the asset used to fund the GRAT appreciated in value by $100,000 during the GRAT term. At the termination of the GRAT, a total of $99,950 of value will have escaped gift taxation (total appreciation of $100,000, less the $50 taxable gift).

## A Typical GRAT Strategy

GRATs may be funded with virtually any type of asset. Typically, GRATs are funded with income-producing property, such as closely-held business interests, marketable securities, venture capital investments, stock options, and/or real estate.

With interest rates at their current historic lows, many individuals have funded GRATs with a well diversified portfolio of marketable securities. As noted above, if the portfolio appreciates at a rate greater than the IRS rate (approximately 2 percent currently), the excess will be transferred without a gift tax.

When funded with closely-held business interests (whether an operating business or rental real estate), certain valuation discounts may be taken from the underlying value of the asset used to fund the GRAT. For instance, a minority interest in an enterprise normally has no authority to appoint officers, establish salaries, or control dividend payments. In addition, closely-held business interests typically contain restrictions prohibiting its owners from transferring the business interests to third parties. As a result of these attributes, discounts are frequently taken for "lack of control" and "lack of marketability." In those situations where the closely-held business interest is sold during the GRAT term or the business interests generate sufficient cash flow for the annuity payments, the assets transferred at the termination of the GRAT are substantially greater.

## Income Tax Considerations

For income tax purposes, payments made by a GRAT to the grantor are not income to the grantor. However, income and gains earned by the GRAT are includible in the grantor's income annually. Typically, a GRAT is structured so that the grantor may be reimbursed by the GRAT for any resulting tax liability. But if the grantor elects not be reimbursed by the GRAT, the value of the GRAT at the end of the term is higher (therefore increasing the value of property escaping gift tax).

## Too Good To Be True?

While it might seem that a GRAT strategy is too good to be true, a GRAT strategy is not without certain drawbacks and pitfalls.

If the grantor dies prior to the expiration of the GRAT, then all (or a portion of) the GRAT assets are included in the grantor's estate for estate tax purposes. While this result essentially eliminates the main tax benefit of the GRAT (i.e., avoiding gift tax on the appreciation of assets in the GRAT), the grantor is no worse off for having engaged in the GRAT strategy (except for the costs of creating and administering the GRAT).

Due to this "mortality risk," it is frequently advisable to establish GRATs with shorter terms, such as two years or three years. Many individuals engaged in the GRAT strategy will structure several short-term GRATs over a period of years to mitigate this mortality risk. For example, it is common to establish a three-year GRAT in year one, then another three-year GRAT in year two, and another three-year GRAT in year three. In this scenario, if the grantor dies in year four, then the appreciation of the three-year GRAT established in year one will have been transferred free of gift tax. If instead, the grantor established a five-year GRAT in year one, then the grantor's death in year five will have eliminated the benefit of the GRAT strategy.

Another potential risk of the GRAT strategy is investment performance. When the assets in the GRAT do not appreciate at a rate that is higher than the rate set by the IRS, there are no assets remaining in the GRAT to transfer to the GRAT beneficiaries. But again, under this scenario, the grantor is no worse off for having engaged in the GRAT strategy (except for the costs of creating and administering the GRAT).

Finally, a GRAT may not be appropriate for making transfers to grandchildren. Special "generation skipping" tax rules apply to GRATs that are beyond the scope of this article. However, depending upon the circumstances, GRATs may not be the best vehicle to shift wealth to grandchildren.

## Act Now

GRATs are viewed as one of the most powerful and tax efficient wealth transfer tools available today. In fact, GRATs have become so popular for transferring wealth, that Congress is considering legislation that will impose restrictions on GRATs. These new GRAT restrictions would require that GRATs have a minimum term of least 10 years. This will, of course, increase the mortality risk of the GRAT strategy, especially for older individuals looking to engage in a GRAT strategy.

So if a GRAT strategy is right for you, don't delay. Rates are at historic lows and Congress has not yet eliminated this extremely effective estate planning strategy.

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