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Transferring Wealth with the Grantor Retained Annuity Trust: GRATifying Results at a Low Cost

By using a GRAT, a client can transfer significantly appreciating assets to family members at a reduced transfer tax cost.

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Adam Jones, age 62, has been your estate-planning client for years. He has run a successful manufacturing business and is nearing retirement. The business is currently valued at $1.5 million. While he had hoped that his children would be interested in taking his place in the business, his daughter, Morgan, is a minister and his son, Troy, is an actor. Over the years, several national corporations seeking to buy the business from Adam have approached him. Adam resisted selling because he hoped that Morgan or Troy would see the light and join the business. Now, resigned to the fact that Morgan and Troy are happy in their own pursuits, Adam's strategic plan for the business is to greatly increase its value over the next few years, and make it a target for a takeover or merger.

While Adam has a sizable retirement plan, he would like to keep it tax deferred as long as possible. Therefore, while he believes the plan will eventually provide for his retirement needs, he is not ready to turn over the proceeds of any business sale to Morgan and Troy. Also, Adam is loath to pay substantial gift taxes, having used most of his applicable exclusion amount in transferring a vacation property to the children some years ago.

On the other hand, Adam foresees a consolidation of the business' industry in the next few years, and he predicts that the business will be sold for a huge profit. Adam realizes that if he waits until the sale of the business, the increase in value of the business resulting from his hard work will be significantly diminished as the IRS takes its 55 percent in gift or estate taxes.

Can you help Adam?

If you are familiar with the grantor retained annuity trust, or GRAT, you may be able to help Adam.

Overview of the Structure of the GRAT

A GRAT is an irrevocable trust established pursuant to Section 2702 of the Internal Revenue Code. In a GRAT, the grantor transfers property and retains the right to receive an annual payment for a fixed term. The payment is set either as a fixed dollar amount or as a percentage of the initial fair market value of the assets transferred to the trust. At the end of the fixed period, the assets remaining in the trust will pass either outright to, or continue in trust for, the beneficiaries named in the trust.

While the Internal Revenue Service generally has imposed severe limitations on the grantor taking into account the value of a retained interest when valuing a gift to a trust for family members,[1] it has specifically provided that in the case of a GRAT that meets IRS requirements, the taxpayer can take into account the value of his or her retained interest in valuing the gift to the trust.[2]

A GRAT presents significant estate-planning opportunities because of the method by which the IRS requires that the grantor's retained interest be valued. Basically, that method requires calculating the present value of each of the annuity payments, using the rate set forth in tables under Section 7520 of the Internal Revenue Code. This rate, which changes monthly, was 7.4 percent for December 1999.

If the property in the trust actually grows at the Section 7520 rate, then the value of the retained interest and the value of the gift of the remainder for gift tax purposes will mirror the economic reality. If, instead, the trust property grows at a rate greater than the Section 7520 rate, then the property that passes to the remainder beneficiaries at the end of the annuity term will be greater than the value of the gift for gift tax purposes. The growth in the property above the Section 7520 rate will pass tax-free to the remainder beneficiaries.

For the GRAT to accomplish its estate-planning goals, the grantor must survive to the end of the fixed annuity term. If the grantor dies during the annuity term, the trust property will be included in the grantor's estate.

Situations in Which GRATs May Be Most Appropriate

The type of situation in which a GRAT can be most useful is when a client owns assets that are expected to grow at a rate significantly higher than the Section 7520 rate. In the above scenario, because Adam believes that his company will be an attractive target for a takeover, he expects the value of his stock over the next few years to increase significantly and exceed the Section 7520 rate. A GRAT may be an effective mechanism for transferring to his children a portion of the "bump-up" in value of the company, at a minimal gift tax cost. For example, if Adam transfers his stock in the company to a five-year GRAT in December 1999, retaining the right to annual annuity payments equal to 24.65058 percent of the value of the stock when it was transferred to the trust, then the value of the gift to the GRAT for gift tax purposes would be approximately $54,983. If the stock appreciated at an average annual rate of 20 percent over the five-year period, then the principal remaining in the trust at the end of the annuity term (representing the growth in the value of the stock in excess of 7.4 percent) would be $980,884. Consequently, Adam would have succeeded in transferring $980,884 to his children by means of a gift valued at $54,983. Similar results would be possible for a client with closely held stock that is expected to become the subject of a public offering, because the stock is likely to undergo a sudden rapid increase in value.

A GRAT may be an attractive estate-planning device for Adam because he does not want to part with all of his stock immediately. By using a GRAT, Adam can select a payment stream and a term of years that meet his needs and will return to him most of the value of the property at the date of the gift. At the same time, he transfers only the right to the appreciation in excess of the Section 7520 rate to the remainder beneficiaries.

The GRAT also offers Adam the opportunity to make a gift with minimal use of the applicable exclusion amount or payment of gift tax. This is possible because he can set the annuity amount and the term of years for which the annuity amount is to be received in such a manner as to render the value of the gift very low. While the IRS has taken the position that one cannot reduce the value of the gift to the remainder beneficiaries to zero,[3] one can come pretty close to what is known as "zeroing out the GRAT." This will be of interest to clients who have used up the applicable exclusion amount and those who do not have the liquidity to pay significant gift taxes.

Planning Tips for the GRAT

Although one cannot reduce the gift tax value of the remainder interest in the GRAT to zero, it is generally thought to be a wise strategy to reduce the value of the gift as much as possible. If one wishes to make a gift that will cause more than minimal gift taxes to be paid, that is best done outside of the GRAT.

One should understand that under a zeroed out GRAT, if the trust property grows at or below the Section 7520 rate, all of the trust property will be returned to the grantor in the form of the annuity payments, and the remainder beneficiaries will receive nothing. While on the one hand, this result will not have accomplished the client's estate-planning objectives, in that the appreciated trust property will have been returned to the grantor in the form of annuity payments, the grantor is no worse off than if he had done nothing, with the exception of the cost of setting up the GRAT in the first place. If, on the other hand, the property appreciates at a rate significantly higher than the Section 7520 rate, all appreciation in the property in excess of the Section 7520 rate will have been transferred at no transfer tax cost.

Length of the GRAT Term

One practical constraint in the selection of the GRAT term is the age of the grantor. If the grantor dies during the GRAT term, the trust property will be taxable in the grantor's estate at the date of death value. Therefore, it is important to choose a fixed term that the grantor has the probability of surviving. One major risk with the longer-term GRAT, however, is that the donor will die before the expiration of the annuity term, resulting in a failure to achieve any benefits from the GRAT. For that reason, one strategic decision is whether to use a long-term GRAT within the life expectancy of the donor, a number of shorter-term GRATs with different terms, or a number of consecutive short-term GRATs (called rolling GRATs).

The risks inherent in using shorter-term rolling GRATS are: (1) the Section 7520 rate will increase at the time that successive short-term GRATs are to be funded; (2) the possibility that the IRS may change the law to abolish the GRAT, thus foreclosing the implementation of successor GRATs; and (3) the added costs of drafting and administering multiple trusts. Despite the disadvantages, the shorter-term GRAT is often used to increase the chances that some tax savings will be achieved even if the grantor dies before his or her life expectancy.

Varying the Annuity Amount

In structuring the level of the annuity amount, it is possible to vary the level of the annual payment from year to year within limits set by the IRS. The amount of the annuity payment may increase, but not more than 20 percent from the previous year's payment.[4] The ability to increase the annuity amount may be used when it is expected that the income from trust assets may increase over time. Keeping the annuity amount low when income is projected to be low will minimize the necessity to pay out the annuity amount in kind in the form of the appreciating asset, the goal being to keep the appreciating asset in the trust, where it can pass to the remainder beneficiaries. The increasing annuity payment also delays the time when assets are distributed from the trust. This permits additional growth within the trust, which may inure to the benefit of the remainder beneficiaries.

Selecting GRAT Assets

If a client has several assets that are all candidates for a GRAT, it is generally advisable to separate out the assets into different single-asset GRATs. If the assets are aggregated in a single GRAT, then the appreciation over the Section 7520 rate in one asset may need to be used to pay the annuity amount when another asset in the GRAT has not appreciated up to the Section 7520 rate. By separating out the assets into separate GRATs, the excess appreciation in one GRAT can pass to the remainder beneficiaries, while the consequences of the underperforming asset in the other GRAT will fall upon the donor through the depletion of the GRAT in payment of the annuity amount.

Income Tax Treatment of the GRAT

It is advantageous for a number of reasons to structure the GRAT as a wholly owned grantor trust for income tax purposes.[5] This means that all the income of the trust is taxable to the grantor, thus permitting the trust property that will eventually pass to the remainder beneficiaries to grow without reduction for the payment of income taxes. Grantor trust status will also insure that neither the transfer of property to the trust by the grantor nor the transfer of property from the trust to the grantor in satisfaction of the annuity amount will trigger the realization of gain or loss. In addition, a GRAT that is a grantor trust is permitted to hold S corporation shares during the annuity term.

Generation-skipping and GRATs

GRATs should generally not be used as generation-skipping vehicles. The period during which the grantor is to receive the annuity is an ETIP, or estate tax inclusion period, and this prevents the allocation of GST exemption to the trust when it is funded.[6] Therefore, a GRAT is often drafted to have only children as beneficiaries, with the grantor to make provision by will for an equalizing payment from other assets to the issue of a deceased child.

Drafting the GRAT Instrument

When drafting a GRAT, it is extremely important to consult the regulations promulgated with respect to Section 2702.[7] The regulations require the inclusion of a number of specific provisions in the GRAT to permit the value of the retained interest to be considered in valuing the gift for transfer tax purposes. For example, the GRAT instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified annuity during the term of the qualified interest;[8] it must prohibit commutation (i.e., prepayment) of the interest of the term holder;[9] it must prohibit additional contributions to the trust;[10] and it must include specific provisions dealing with the payment of the annuity amount during short taxable years.[11] Under new proposed regulations in 1999, the governing instrument must also prohibit satisfying the annuity amount with notes, other debt instruments, or options.[12] The IRS may refuse to give effect to an amendment of the trust after it has been funded to include any of the omitted required provisions; therefore, it is particularly important to comply with the IRS requirements when the trust is initially drafted.

Alternatives to the GRAT

If a client has assets that are expected to appreciate significantly, the estate planner should be prepared to discuss a full array of gift and estate-planning options. Transfer of the appreciating assets to a family limited partnership and giving family limited partnership interests either outright to the client's beneficiaries or contributing the family limited partnership interests to a GRAT may fit the client's needs. An estate-planning device often compared to the GRAT is an installment sale of the appreciating asset to an "intentionally defective" grantor trust. This vehicle has both advantages and disadvantages when compared with the GRAT. Only by analyzing the pros and cons of each approach in light of the client's specific needs and risk tolerance can the appropriate course for a particular client be charted.

Conclusion

For a client such as Adam, who owns assets that can be expected to appreciate rapidly, the estate-planning opportunities afforded by the GRAT should be seriously considered by those who wish to transfer significantly appreciating assets to family members at a reduced transfer tax cost. If he funds a GRAT now, Adam may succeed in passing significant wealth to his children free of gift and estate tax. Such results can indeed be GRATifying.

Endnotes

1. *See generally* I.R.C. §§ 2036, 2038, 2701–2703.
2. *See* I.R.C. § 2702(a), (b).
3. *See* Treas. Reg. § 25.2702-3(e), Ex. 5.
4. Treas. Reg. § 25.2702-3(c)(1)(ii).
5. *See* I.R.C. §§ 673–677 (for those circumstances in which a grantor of a trust may be treated as the owner of all or a portion of a trust for federal income tax purposes).
6. *See* I.R.C. § 2642(f).
7. *See generally* Treas. Reg. § 25.2702-3.
8. Treas. Reg. § 25.2702-3(d)(2).
9. Priv. Ltr. Rul. 94-12-036 (March 25, 1994), Treas. Reg. § 25.2502-3(d)(4).

10. Treas. Reg. § 25.2702-3(b)(4).

11. *See* Treas. Reg. § 25.2702-3(b)(3).

12. Definition of a Qualified Interest in a Grantor Retained Annuity Trust and a Grantor Retained Unitrust, 64 Fed. Reg. 33,235 (1999) (to be codified at 26 C.F.R. pt. 25) (proposed June 22, 1999).