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GRATs Are Great For Large Estates

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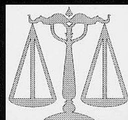

SPECIAL FEATURE

Tax & Estate Planning

Despite its complexity, the GRAT remains a valuable tool for achieving dramatic estate and gift tax savings, and should be taken into consideration when counseling clients on their estate planning needs.

In these times of fluctuating estate tax legislation and an unsteady economy, it is increasingly important to find strategies that provide long-term protection for your client's estate. It is incumbent upon practitioners to present their clients with options that will yield the maximum rate of return for their beneficiaries.

Proper estate planning requires a thorough understanding of the client's goals and objectives. Only then can the attorney design and implement wills, trusts and asset title and beneficiary designations that will achieve the stated objectives.

An effective estate plan includes strategies for probate avoidance, asset protection and tax savings opportunities. It also involves choices regarding the manner in which the inheritance will be distributed or held in trust upon the death of the client's beneficiaries, most often the children.

Oftentimes, however, a solution created to achieve one estate planning goal is an impediment to another. Establishing joint ownership of assets, for example, may avoid probate if there is a survivor — but the deceased owner then loses control over whether the assets stay in the immediate family.

Planning for business owners and others with large estates usually includes one or more lifetime gifting techniques. These techniques primarily aim to reduce estate tax. They include irrevocable trusts, valuation discount planning with family limited partnerships and LLCs, intentionally defective grantor trusts and the like. In the end, these can produce dramatic savings for the client's family.

Unlike the type of planning done with wills and revocable trusts, which does not take effect until death, lifetime gifts come at the cost of losing control to varying degrees. Lifetime gifts cannot freely be changed or taken back once given. For this reason, it is even more critical to understand the client's long-term objectives, and plan a lifetime gifting program that is consistent with these stated objectives.

For example, a practitioner does not want to be in the position of negotiating for the repurchase of stock in the family business from a child who is never to be involved in the business anyway.

When the gifting plan dovetails with the client's long-term objectives, pure tax savings, with no hidden downsides, can result. One technique that can yield substantial estate tax savings is the grantor retained annuity trust (GRAT). A GRAT is an irrevocable trust. The client, the grantor, transfers assets to the GRAT. GRATs are best when they have potential for significant appreciation, income, or a combination thereof — such as stock in the family business.

The results are enhanced even further when the assets will be valued with a minority interest discount, such as non-voting stock and limited partnership interests. The grantor receives an annuity, which can be paid with cash or other assets from the GRAT at least annually for the length of the term. The term can be a specified number of years, or life.

For simplicity, assume that a specified number of years is chosen. If the grantor dies during the term, the remaining annuity payments will be made to his estate. Once the term is completed, any assets remaining in the GRAT will be distributed or held in trust for the intended recipients of the gift.

In this example, assume it is the grantor's children. The transfer of assets from the grantor (the father) to the GRAT is a gift. The value of the gift is the value of the assets transferred, less the value of the annuity payable to the grantor.

The value of the annuity is determined by many factors, including the interest rate provided under Section 7520 of the Internal Revenue Code. If the combination of income and appreciation on the GRAT assets exceeds the Section 7520 rate, there will be assets remaining in the GRAT to be distributed to the children upon expiration of the specified term.

Further assume, for example, that the father transfers $1 million of stock in the family business to a five-year GRAT, and that the combined rate of income and appreciation on the stock is 15 percent. Also, assume that the Section 7520 rate

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is five percent. The father retains the right to receive from the GRAT 23.09735 percent of its original value, which amounts to $230,974 each year for five years. The present value of the five-year annuity payable to the father is $1 million.

Since the value of the annuity he will receive is equal to the value of the assets transferred to the GRAT, the value of his gift to the GRAT is zero. Because the combined rate of income and appreciation in the stock (15 percent) exceeds the Section 7520 rate that is used to make this calculation (5 percent), there will be $454,043 of assets in the GRAT after the father receives his last annuity payment.

The chart below represents the income and appreciation of the GRAT over and above the required annuity payments made to the father. These remaining assets will be distributed to the children, free of gift and estate tax.

Year	Principal	Growth & Income	Annuity Payment to Dad	Remaining GRAT Assets
1	$1,000,000	$150,000	$230,974	$919,026
2	$919,026	$137,854	$230,974	$825,906
3	$825,906	$123,886	$230,974	$718,818
4	$718,818	$107,823	$230,974	$595,667
5	$595,667	$89,350	$230,974	$454,043
				$454,043

Annuity payments to the father can be made with cash that has been distributed from the business to the GRAT, or with part of the stock that was originally transferred by the father to the GRAT. During the term, the GRAT is generally treated as a grantor trust for income tax purposes.

Thus, the grantor is taxed on the income and realized gains on GRAT assets, even if these amounts are greater than the annuity payments made to the grantor. This is beneficial for tax purposes, as the grantor's payment of income tax liability on assets that will eventually be distributed to the children is not treated as a gift.

The most valid criticism of the GRAT is that the GRAT assets will be included in the estate of the grantor if the grantor dies before expiration of the term. Aside from the costs of establishing and maintaining the GRAT, however, the family is not worse off than if nothing had been done. Opportunities may exist to eliminate even this estate tax risk.

Properly implemented, the GRAT offers a few advantages relative to other effective modern day planning techniques, such as the intentionally defective grantor trust.

First, since assets are transferred to the GRAT for no consideration, no seed money is required. Seed money is generally required for a sale transaction.

Second, there is not a downside (other than transaction costs) if the GRAT assets do not yield income and appreciation less than the Section 7520 rate. The GRAT assets will be exhausted in order to make annuity payments to the grantor, and nothing will be distributed to the children.

Since the annuity payment to the grantor is expressed as a percentage of the original value of the GRAT assets, a third advantage is the elimination of the risk of gift tax liability. The IRS frequently challenges valuations in estate planning transactions, such as a GRAT or an intentionally defective grantor trust.

In the GRAT situation, an increased valuation simply results in a larger annuity payment to the grantor since the payment is expressed as a percentage of the original value. Assuming the GRAT was structured to yield no gift under the prevailing Section 7520 rate, no gift will result from the change in value upon a successful challenge by the IRS. This is particularly important to clients now since they are questioning whether there will be an estate tax in the future. Practitioners should not encourage clients to incur gift tax liability now.

Numerous factors determine the gift and estate tax implications of a GRAT. Despite its complexity, the GRAT remains a valuable tool for achieving dramatic estate and gift tax savings, and should be taken into consideration when counseling clients on their estate planning needs.

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