Grantor Retained Annuity Trusts: An Estate Planning Golden Opportunity

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For the first time since its original enactment in 1916 there is, at least as of the date of this writing, no Federal estate tax. Pursuant to the provisions of EGTRRA, adopted in 2001, the tax has been repealed for a one year period commencing January 1, 2010.[1] In light of current economic conditions and the growing Federal budget deficit, permanent repeal of the Federal estate tax is unlikely and the tax will, if not addressed by the President and Congress this year, return with a vengeance on January 1, 2011 with a $1 million exemption amount and graduated rates topping out at 55%. The Federal gift tax, however, remains in place for 2010 with a $1 million exemption amount and graduated rates maxing out at 35%, the lowest gift tax rate in many years. As of January 1, 2011, the top gift tax rate is scheduled to rise to 55%.

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This article addresses one of several estate planning vehicles appropriate for the current low interest rate environment: the inter vivos trust commonly known as a "grantor retained annuity trust" ("GRAT"). Use of a GRAT is specifically authorized under the Internal Revenue Code and the regulations thereunder.[2] Despite the current legislative uncertainty, GRATs continue to provide a golden opportunity for taxpayers to transfer wealth to their beneficiaries with potentially minimal transfer tax consequences and should be considered by taxpayers as a potential part of their estate plans.

A. What Is a GRAT?

A GRAT is a trust to which a taxpayer irrevocably transfers assets in exchange for an annuity payable to the taxpayer for a fixed term of years selected by the taxpayer ("Fixed Term"). The annuity payments received by the taxpayer may be expressed either as a specific dollar amount or as a percentage of the initial fair market value of the trust. If the taxpayer survives the Fixed Term, any remaining trust assets will pass to the taxpayer's selected beneficiaries free of gift tax. The taxpayer receives back through the annuity payments the initial property he or she transferred to the GRAT and thus retains control and enjoyment of the assets.

The transfer of property to a GRAT is a taxable transfer for gift tax purposes. The value of the gift is equal to the fair market value of the property transferred to the GRAT minus the value of the annuity retained by the taxpayer. To value the annuity interest, the IRS uses the interest rate determined under §7520 of the Internal Revenue Code in effect for the month of the transfer of the property to the GRAT.[3] The §7520 rate for July 2010 is 2.8%, historically a *very* low rate. The IRS assumes the assets in the GRAT will grow at a rate equal to the §7520 rate. The §7520 rate is known as the "hurdle rate" because the assets contributed to the GRAT must appreciate in value above that key rate to pass wealth to the taxpayer's selected beneficiaries.

As of this writing, a GRAT may be structured so that the value of the annuity interest equals the original contribution, thereby causing the value of the gift to be minimal (if not zero) with no gift tax due on the transfer to the GRAT. Such a GRAT is often referred to as a "zeroed-out GRAT."[4]

B. Objectives

The primary objective of a GRAT is to transfer to the taxpayer's beneficiaries any appreciation in the GRAT property over the applicable §7520 interest rate, with minimal or no gift tax cost. In a near zero GRAT, if the property grows faster than the applicable §7520 interest rate (2.8% in July 2010), any appreciation in the GRAT assets over the applicable §7520 interest rate passes to the taxpayer's beneficiaries gift tax free, provided the taxpayer survives the Fixed Term of the GRAT. With applicable interest rates near historic lows, the chances of a successful GRAT are substantially increased.

C. Estate Tax Consequences

If the taxpayer does not survive the Fixed Term, the property transferred to the GRAT is includible in the taxpayer's gross estate, which is the same result as if the property had not been transferred to the GRAT. Accordingly, other than legal, accounting and possibly appraisal costs, there is essentially no estate planning risk, as a taxpayer who does not survive the Fixed Term is in the same position as if he or she had not created the GRAT. If the taxpayer does survive the Fixed Term, any appreciation in the GRAT property over the hurdle rate is removed from the taxpayer's gross estate. A GRAT can thus achieve an estate tax freeze with potentially nominal or no gift tax cost.

D. Income Tax Consequences

A GRAT is a grantor trust for income tax purposes, meaning that the taxpayer is responsible for the payment of income taxes incurred by the GRAT.[5] While grantor trust status may not initially appear to be advantageous or desirable, the GRAT assets grow income tax-free. Payment of the income taxes by the taxpayer is thus essentially an additional tax-free gift to the GRAT beneficiaries. Because the income and capital-gains tax rates are historically lower than the gift and estate tax rates, grantor trust status allows the taxpayer to pass on more wealth to his or her beneficiaries.

E. Does the 2010 Repeal Period Provide Special Planning Opportunities for GRATS?

The absence of a Federal estate tax would impact taxpayers who have created a GRAT and do not survive the Fixed Term, dying during the year 2010 and causing the GRAT assets to be includible in the taxpayer's gross estate. While no Federal estate tax would result (at least as of the date this article goes to publication), such a GRAT will not have achieved its purpose of transferring to the taxpayer's beneficiaries any appreciation in the GRAT property.

Most appealing in 2010 are the low Federal gift tax rates (topping out at 35%). For those taxpayers who are considering creating a non-zeroed-out GRAT in excess of the $1 million gift tax exclusion or who have made previous gifts which have used up their exemption, the lower gift tax rates in effect in 2010 afford an opportunity to make gifts at a substantially reduced gift tax cost. The low gift tax rates will not impact those taxpayers creating zeroed-out GRATs or taxpayers creating GRATs within their $1 million gift tax exemption.

Taxpayers should weigh their 2010 planning opportunities against the possibility that Congress may enact legislation for calendar year 2010 restoring the Federal estate tax and the 2009 transfer tax rates, which legislation may be retroactive to January 1, 2010.[6]

F. Proposed Legislation

Federal legislation is pending that would limit the use of certain types of GRATs.[7] The legislation would: (i) require that GRATs have a minimum term of ten years; (ii) require that GRATs have some minimum remainder interest; and (iii) preclude the use of GRATs where the annuity amounts decrease during the first ten years of the trust term. The legislation would apply to transfers made after the date of enactment.

G. Viability of GRATS if Proposed Legislation Is Passed

Unless and until the proposed legislation limiting the use of GRATs is enacted into law, zeroed-out GRATs remain a viable planning opportunity. Even if the legislation is enacted, utilization of GRATs within the confines of the proposed legislation will continue to offer substantial transfer tax savings opportunities, especially in the current low interest environment. For taxpayers who may be considering creating one or a series of zeroed-out GRATs, the possibility of enactment of the proposed legislation is an incentive to act now.

H. When Should a Taxpayer Consider Using a GRAT?

A GRAT may be particularly appropriate for taxpayers with assets in excess of the applicable exemption amount (which under current law is scheduled to be $1 million as of January 1, 2011) and who wish to make lifetime gifts in excess of the $13,000 annual per donee exclusion. GRATs may be structured in a variety of ways, but should be used only when the taxpayer is expected to survive the Fixed Term and are most effective when funded with assets that may be expected to outperform the applicable §7520 rate (either because the asset is an income-producing asset, an appreciating asset or both). Assets that are entitled to valuation discounts such as that for lack of marketability or minority interests, or that are temporarily depressed immediately prior to the transfer to the GRAT, are also excellent candidates for a GRAT. GRATs may be structured in many different ways, depending upon the taxpayer's age, health, personal and long term objectives, income tax considerations and assets.

Endnotes

1. Economic Growth and Tax Relief Reconciliation Act of 2001. Pub. L. No. 107-16, 115 Stat. 38 (2001).
2. 26 U.S.C. §2702(b) and C.F.R. §25.2702-3. GRATs are a statutory exception to the general rule of Internal Revenue Code §2702(a), which ascribes a zero value to the retained interest for transfers in trust to or for the benefit of specified members of a taxpayer's family. 26 U.S.C §2702(a) and C.F.R. §25.2702-1. Valuation of the retained interest at zero results in the full amount of the property transferred in trust (the remainder interest) to be valued at full value.
3. The §7520 rate is published monthly by the IRS pursuant to Internal Revenue Code §7520 and is used to calculate the present value of term interests, life interests, annuities and remainders. 26 U.S.C. §7520. It is 120% (rounded to the nearest 2/3 of 1%) of the applicable federal rate for mid-term obligations with semi-annual compounding ("AFR"). AFRs are calculated and published by the IRS monthly for use in the following month, based on the previous month's weighted average market yield for marketable Treasury obligations of the same duration and with semi-annual compounding of interest. 26 U.S.C. §1274(d).
4. *See Walton v. Comm'r*, 115 T.C. 589 (2000).
5. 26 U.S.C. §677.
6. *See* CCH Tax Briefing, *Federal Estate Tax (H.R. 4254)*, (CCH), December 28, 2009; David Kocieniewski, *Legacy for One Billionaire: Death, but No Taxes*, N.Y. Times, June 8 at A1.
7. Passed by the House of Representatives on March 24, 2010, H.R. 4849, 111th Cong. (2010), but not acted upon by the Senate, the legislation was reintroduced in the House as part of the Small Business Jobs Tax Relief Act of 2010, H.R. 5297, 111th Cong. (2010), passed on June 15, 2010.

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