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“THE TIME IS RIGHT FOR GRATS”

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For those seeking to preserve their wealth for the next generation, the Grantor Retained Annuity Trust (GRAT) is a moderately aggressive estate tax planning tool that thrives in asset appreciating economic environments. Although assets values are not in the appreciation mode right now, the currently depressed asset values coupled with extremely low interest rates lay the foundation for a timely opportunity to establish a GRAT.

A GRAT allows a person, called the grantor, to transfer significant assets to family members with very little transfer tax consequences and to retain almost all of the income from the transferred asset for a period of years. Under a GRAT, the grantor transfers assets to an irrevocable trust and retains the right to receive a fixed annuity for a term of years. The annuity is designed to return to the grantor the entire amount of the initial gift plus interest at a Federally designated interest rate, referred to as the AFR. This rate is currently 2.3%. At the end of the term of the GRAT, when all of the annuity payments to the grantor have been made, the remaining assets in the GRAT pass to designated beneficiaries (i.e. children) outright or to trusts for their benefit, free of transfer taxes. At that point, all of the growth of the trust assets in excess of 2.3% is then outside of the grantor's estate and not subject to estate tax upon the grantor's death.

Rate of Return of Assets transferred to a GRAT vs. AFR

The assets transferred to the GRAT are ideally assets expected to appreciate significantly over the term of the GRAT. They may consist of cash, stocks, mutual funds, real estate, or other investments and income producing property. ***In order for the GRAT to be successful, the total return on assets transferred to the GRAT must exceed the AFR.*** Therefore, with the current AFR set extremely low (2.3%), it is easier for a GRAT to outperform the AFR and transfer the excess appreciation in assets to designated beneficiaries.

If the total return of the GRAT assets is less than or equal to the AFR, the entire GRAT property will be returned to the grantor, but at no cost to the grantor, other than the cost of creating the GRAT and any loss in value in the assets of the GRAT.

Grantor Does Not Survive GRAT Term

If the grantor passes away during the GRAT term, the remaining trust assets are includible in the grantor's gross estate and subject to federal estate tax. In that event, there is no tax benefit (or tax cost) associated with the gift.

Nominal Gift

The amount of the taxable gift (the remainder interest) is computed by subtracting the present value of the annual annuity payments to the grantor from the fair market value of the assets transferred to the GRAT. The annuity, however, can be structured so that its value absorbs almost the entire value of the assets transferred to the GRAT resulting in a nominal gift.

Grantor Trust Status

The GRAT is also treated as a grantor trust for income tax purposes. Because the grantor pays the income taxes on trust income, the trust will grow income-tax free and the payment of the taxes by the grantor is, in effect, a tax-free gift to the children.

GRAT Property and Term

When creating a GRAT one should consider: (1) the type of property transferred to the GRAT; and (2) the duration of the GRAT term. A grantor should fund a GRAT with property that he or she believes will appreciate at a rate that exceeds the AFR. With respect to the term of the GRAT, a longer-term GRAT locks in the current low interest rate, however, a series of short-term GRATs, or "rolling GRATs" may be more effective if the rate of investment return is expected to fluctuate.

Rolling GRATs

The utilization of rolling GRATs allows the grantor to roll the assets out of one GRAT and into the next GRAT. For example: if after the first year of a GRAT term, the grantor receives back stock that has not increased in value, but the grantor believes will increase in value in the future, the grantor can create a second GRAT. This second GRAT will have similar terms as the first GRAT, although the AFR may have changed. The grantor can then take the assets which were distributed back to him from the first GRAT, add some additional assets and start a second GRAT.

Separating GRAT Assets

Another GRAT strategy involves the isolation of different securities or a collection of similar securities in separate GRATs. This can maximize the likelihood of a successful GRAT and eliminate the poor performance of a few stocks dragging down an otherwise well-performing GRAT.

Staggered Annuity Rate

The annuity payable to the grantor does not have to be constant over the GRAT term. The annuity may be established by a formula which increases the annuity by up to 20% of the previous year's annuity. This can maximize the amount of assets available for the GRAT to invest during the early years of the GRAT term.

The time is ripe for GRATs notwithstanding today's economy. First, asset values have contracted dramatically. Second, the promulgated interest rates applicable to GRATs are historically low, which lowers the bar for asset appreciation required to make the GRAT effective. Third, our lawmakers, in the exercise of their infinite wisdom, are considering legislation aimed at GRATs, which may significantly reduce their effectiveness.

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