Grantors face lots of uncertainties in today’s economy as they plan for wealth transfers. Credit markets have tightened, stock markets worldwide are swinging wildly, and the Federal Reserve and Central Banks are lowering interest rates. Congress is bailing out Wall Street and another economic stimulus package is likely. Other governments are considering similar actions.

Adding to market uncertainty is legal uncertainty. The repeal of federal wealth-transfer taxes on estates is scheduled for 2010; without action by Congress, these transfer taxes will be reinstated in 2011. Both parties show some support to retain the tax (i.e., repeal the repeal).

The grantor retained annuity trust (GRAT) and its variant, the grantor retained unitrust (GRUT), may provide current and future tax benefits for family wealth transfers in the face of this uncertainty. They are based on the assumption that assets likely will appreciate at a higher rate than the rate the government uses to determine the amount of a transfer subject to taxation. There also may be market or minority discounts for closely held businesses, allowing asset appreciation to transfer tax-free. This article explores the benefits and pitfalls of using these wealth-transfer planning techniques.

Grantor Retained Annuity Trust (GRAT)

To establish a GRAT, the grantor transfers assets into an irrevocable inter vivos (i.e., between living persons) trust for the benefit of one or more beneficiaries. The grantor retains an annuity interest for a term of years, life, or a combination thereof. At the end of the retained interest period, the assets are distributed to the beneficiaries.

The GRAT provides gift tax relief to beneficiaries that otherwise might be unavailable. General rules for determining gift value for tax purposes are set forth in IRC §2702. Under those rules, any interest retained in a trust by the grantor or other applicable family member who isn’t a “qualified interest” is treated as having zero value. Under this zero-value rule, the gift value is determined by subtracting the value of the interests retained. But because this retained value is zero, the entire amount transferred is taxable.

Example: Jane transfers $100,000 of property to an irrevocable trust, retaining the right to receive the income of the trust for 10 years. Jane is allowed to make additional contributions to the trust. If Jane dies before the 10-year period expires, the entire corpus is paid to her estate. The value of Jane’s retained interest is zero and thus the value of the gift is the fair market value of the property transferred to the trust.

Qualified Interest

But the zero-value rule doesn’t apply to “qualified interests,” which under IRC §2702(b) can be of two types:

1. any interest that consists of the right to receive fixed amounts payable at least annually (a GRAT) or
2. any interest that consists of the right to receive amounts payable at least annually and are a fixed percentage of the annually determined fair market value of the property in the trust (a GRUT).

Thus the term of a GRAT annuity must be equal to a specified term of years, the life of the annuitant, or the shorter of those two periods.

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A “qualified interest” can be held by the grantor or any applicable family members (a spouse; any ancestors or lineal descendents; brothers, sisters, or their spouses).

Qualified Annuity Interest

Treasury Regulation §25.2702-3(b) sets the following requirements for GRAT or GRUT “qualified annuity interests,” i.e., the interest held by the grantor/annuitant that is valued under Chapter 14 valuation rules rather than the zero-value rule.

1. The interest must be an irrevocable right to receive a fixed amount, payable to or for the benefit of the holder of the annuity interest at least annually.
2. The annuity payment must be made with cash or other trust assets, and the GRAT’s governing instrument must prohibit the trustee from issuing a debt obligation in satisfaction of the annuity payment obligation.
3. The GRAT’s governing instrument must provide for adjustments for incorrect valuation (if the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property).
4. The annuity amount must be prorated in the case of certain short periods.
5. The annuity payment must be made no later than the anniversary date of the trust or the due date of the GRAT’s income tax return for the tax year, depending on when the annuity is payable.
6. The GRAT’s governing instrument must prohibit additional contributions to the trust.
7. The GRAT’s governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified interest during the term.
8. The GRAT’s governing instrument must fix the term of the annuity interest, and the term must be for the life of the term holder, for a specified term of years, or for the shorter of those two periods.
9. The GRAT’s governing instrument must prohibit prepayment of the interest of the term holder.
10. The interest must be a qualified annuity interest in every respect from the creation of the GRAT. Again, a GRAT or a GRUT must be irrevocable and meet the above requirements. A fixed amount is defined as a stated dollar amount or a fraction of the initial fair market value of the transferred property. It must be paid periodically, but at least annually. The payment may not exceed 120 percent of the amount payable in the preceding year.6 Failure to meet these requirements will result in zero-value rules applying to the gift.

The annuity must be paid to the grantor regardless of whether the trust has produced income sufficient to pay the annuity amount. The trust instrument must require that the trustee actually pay the annuity amount and not just grant a right to receive it. If trust income is insufficient, the trustee must be required to invade the corpus to pay the annuity. A note, other debt instrument, option, or similar financial arrangement may not be used, directly or indirectly, to pay the annuity amount.3

Valuation of a GRAT
If the interest is a qualified annuity interest, its value is determined under IRC §7520: The grantor determines the fair market value of the assets transferred to the GRAT and subtracts the value of the retained annuity.

IRC §7520 provides for an assumed rate applicable to the valuation of the retained interest; the IRS publishes this rate monthly. The rate also may be 120 percent of the federal mid-term rate in effect under section 1274(d)(1).a The lower the federal mid-term rate, the smaller the gift.

If the interest is a term of years, reference the IRC §7520 rate and Table B. If it is for life, reference the IRC §7520 rate and Table S. If the annuity is paid more frequently than annually, then an adjustment factor from Table K must be applied. The tables can be found in IRS Publication 1457.

Generally, a GRAT is more attractive when the IRC §7520 rate is low and the market value of the assets is expected to increase at a greater than the §7520 rate.

Is a GRAT Appropriate?
Because a GRAT’s effectiveness depends on the IRC §7520 rate, asset growth, and the type of property transferred, it may or may not be appropriate for a given investor.

Generally, a GRAT is more attractive when the IRC §7520 rate is low and the market value of the assets is expected to increase at a rate greater than the IRC §7520 rate. If the IRC §7520 rate decreases, the value of the retained interest in a GRAT increases because the reduced rate makes the right to receive fixed amounts in the future more valuable. The more valuable the retained interest, the less gift tax will be paid on the transfer.

Example: Lauren transfers $100,000 to an irrevocable trust and retains the right to receive annual payments from the trust of $10,000 for 10 years. At the end of term, the trust will terminate and the corpus will be distributed to her son, Eric. Lauren’s retained interest is considered a qualified annuity interest, so it is valued under IRC §7520. If the §7520 rate at time of transfer is 4 percent, the value of the annuity is $81,109.00 (8.1109 x $10,000). The remainder is $18,891 ($100,000–$81,109) for gift-tax purposes. If the §7520 rate at time of transfer was 8 percent, the value of the annuity would be $67,101.00 (6.7101 x 10,000) and the remainder for gift-tax purposes would be $32,899 ($100,000–$67,101). Thus if the rate increases the...
Discounts for Closely Held Businesses

Value of a transfer may be further reduced by applying minority or marketability discounts available for closely held businesses. The government provides the discount to encourage investment that will stimulate the economy. The retained interest is subtracted from the discounted value of the property transferred, resulting in a smaller taxable asset. Thus these types of assets are very appropriate for use in GRATs. If an asset appreciates at a rate greater than the IRC §7520 rate, then the amount the beneficiary receives will be greater than the value of the gift for gift-tax purposes. As a result, wealth has been transferred without the full application of wealth-transfer taxes.

Best Assets for a GRAT

Equity investments typically are used to fund a GRAT. These types of assets have a greater potential for appreciation than traditional fixed-income assets. Often, grantors will put in speculative equity investments with the hope that they will increase in value.

As noted above, closely held business assets are popular because of possible discounts.

Generation Skipping Transfer Tax

The government assumes wealth transfer from parent to child to grandchild and so on. As each lineal descendant dies or makes a gift to the next generation, the government assesses wealth-transfer taxes. Skipping generations, for instance with a transfer from a grandparent to a grandchild, cheats the government out of a layer of taxation. This has resulted in a separate tax known as the Generation Skipping Transfer Tax (GSTT), a tax on transfers that skip a generation. The GSTT rate is a flat 45 percent for transfers in 2008.

Three types of skips are subject to GSTT. A direct skip is a transfer directly to a skip person. A skip person is a person two or more generations below the grantor (e.g., a grandchild). A distribution skip takes place when assets, including cash, are distributed to a skip person. For example, a trust is established and the trustee is authorized to make distributions of income to a skip person. A termination skip occurs upon the termination of a trust when the corpus is distributed to a skip person.

In a direct skip, tax is applicable at the time of the transfer. In a distribution skip, tax is paid each time a distribution is made. In a termination skip, tax is paid at the time of the termination distribution.

The GSTT has an exemption of $2 million in 2008; a spouse can elect to split the gift and double the exemption; splitting a gift allows a spouse to transfer property that is held in his/her name and “use” each spouse’s exemption amount.

A GRAT generally is not appropriate for a generation-skipping transfer because the government considers the initial transfer of assets to be to the trust (not to the beneficiary), and it considers the generation-skipping transfer as a termination skip (because the grantor’s interest in the GRAT terminates). As a result, the GSTT exemption is lost because the exemption must be applied when the GRAT terminates.

Death of the Grantor

GRAT assets are distributed at the end of the grantor’s term. The GRAT may be included in the grantor’s estate if the grantor dies before the term ends or the GRAT term is the grantor’s life. If the grantor survives the fixed-term GRAT, depending on the market, the full intended tax benefits would be obtained. If an interest is included in the grantor’s estate, the grantor may use life insurance to cover the risk of death during the GRAT term.

If, under the terms of the trust, after the grantor’s death the remaining annuity payments pass to the surviving spouse, care must be taken to ensure that the interest qualifies for the IRC §2056 marital deduction for estate-tax purposes. The trust and or other estate-planning documents should provide that if the grantor’s spouse survives...
the grantor, the annuity payments will qualify for the deduction. They must pass either outright to the surviving spouse, the estate, or to a marital trust over which the spouse has a general power of appointment.

The IRS issued regulations effective July 14, 2008, clarifying the valuation of the amount included in the grantor’s estate. First the IRS confirmed that the GRAT interest included will be under IRC §2036 and not IRC §2039, dealing with other retained annuity property.

The IRS stated:

When the transferor retains an annuity or similar interest in the transferred property (as in the case of a GRAT or GRUT), the transferor is not selling the transferred property to a third party in exchange for an annuity because there is no other owner of property negotiating or engaging in a sale transaction with the transferor. The transferor, instead, is transferring the property subject to a retained possession and enjoyment of, or right to, the income from the property. If the grantor retains the interest for life, for any period not ascertainable without reference to the grantor’s death, or for a period that does not in fact end before the grantor’s death, the property is subject to inclusion in the grantor’s gross estate under section 2036.

Secondly, the value that may be included in the deceased grantor’s gross estate is that portion, valued as of the grantor’s death (or the IRC $2032 alternate valuation date), necessary to yield that annual annuity, unitrust, or other payment without reducing or invading principal. In making this determination the IRC §7520 rate in effect on the decedent’s date of death (or on the alternate valuation date) is used.

Zeroed-Out GRAT

GRAT tax benefits will be maximized if the value of the retained interest is equal to the fair market value of the assets placed in the trust. This could result in a gift of little or no value—a zeroed-out GRAT.

The IRS has challenged this zero-out opportunity. In its former Example 5 under Treasury Regulation §25.2702-3(e), the IRS provided that the computation of the taxable gift at the creation of the GRAT always has a mortality component and the value of the remainder interest in the GRAT could never be zero, so there would always be a value for tax purposes. The tax court resolved this issue in Walton v. Commissioner, 115 T.C. 41 (2000), and the IRS has acquiesced to this case and revised Example 5.

Before Walton, the IRS position was that even if a grantor retained the right to receive an annuity over a fixed term, the value of the qualified annuity interest was determined as though the right to the annuity was retained for the shorter of the fixed term or until the grantor’s death. The right to receive an annuity for the shorter of an individual’s life or a fixed term was valued at least than the right to receive an annuity for the entire fixed term. The retained interest could be valued only if the grantor would receive it during life. If it is assumed the grantor will die during the term, the value of any interest that would pass at death is not included in valuing the retained annuity. This increased the value of the gift and eliminated any possibility of a zeroed-out GRAT.

The tax court in Walton held that Example 5 was an unreasonable interpretation and thus invalid. As a result, value of an annuity payable over a term to the grantor and to the grantor’s estate if the grantor dies before the end of the term is not reduced by the value of the contingent interest. Therefore, a fixed GRAT period may provide that it will not terminate if the grantor dies during the GRAT term. A GRAT pays an annuity to the grantor during his/her lifetime and, if the grantor dies before the end of the term to his/her estate, then there will not be a reduction as under the prior IRS interpretation. As a result, with proper planning the value of the retained interest may reduce the value of the gifted interest to zero or near zero. If the assets appreciate in value there is no gift tax on the appreciation.

Example: Liz establishes an inter vivos trust with $1 million of assets and retains a qualified annuity interest entitling her to three annual payments of $360,347.38. At the expiration of the term (three years) the corpus is payable to her son, Johnny. Assume that the $7520 rate is 4 percent and the growth rate on the assets transferred is 8 percent over the term. The value of the retained annuity is $1 million, so the gift will zero out and there will be no taxable gift. Income earned over the three-year period totals $170,922.41. Payments to Liz total $1,081,042.14 (or $360,347.38 x 3). At the end of the three-year term, Johnny gets $89,880.27 (or $1,000,000 + $170,922.41 – $1,081,042.14) free of tax.

Example: Assume the same facts as above except that the annuity term is 10 years with annual payments of $123,290. The retained interest will be valued at $999,993 and the taxable gift is: $7 ($1,000,000–$999,993). Interest earned over the 10-year period will total $605,777. Payments to Liz total $1,232,900 (or $123,290 x 10). At the expiration of the term, Johnny will receive the remainder, $372,877, free of additional tax.

Example: If the growth rate had been higher in the above example, the benefit would be even greater. Assume a growth rate of 15 percent. Interest earned over the 10-year period would total $1,775,212, and the amount distributed to Johnny at the end of the period would
be $1,542,312. If discounts were available on the initial transfer, then even more value could be transferred tax-free at the end of the annuity period. If the property transferred were an interest in a closely held business that commanded a 40-percent discount, the value of the distribution would not be subject to wealth-transfer taxes.

Other Benefits of the GRAT
Individuals who establish GRATs in a down market may see considerable growth in their assets on a market upswing. The key is the type of investment, and the interplay of the IRC §7520 rate and the expected return on the assets. However, a down market has a downside. If IRC §7520 rates rise, assets must appreciate by more than the new, higher rates. Generally, GRATs will not be as viable when the market is peaking, because it may be harder for the asset value to appreciate. Thus a properly planned GRAT allows an individual to leverage transfers to children, and as long as the assets’ value appreciates by more than the §7520 rate, the children benefit.

A GRAT also may work well for an individual whose assets are expected to outperform the market. An example would be an interest in a company that is expected to go public. Transferring the stock to a short-term zeroed-out GRAT could result in the transfer of a substantial amount of appreciation subject to little or no transfer tax.

Multiple GRATs
It is not uncommon for investors to establish multiple GRATs. Different assets or mixes of assets will be transferred into the various GRATs. This may help with the valuation and hedge against value depreciation of some assets.

Grantor Retained UniTrust
A GRUT is very similar to a GRAT but not as popular. The difference is in the determination of the annuity interest retained by the grantor. In a GRUT, the annuity amount is a fixed percentage of the present value of the trust, which is determined annually, not a fixed amount or fixed percentage of the original investment. The GRAT is less popular then the GRAT because the GRAT is more effective if the trust corpus appreciates. GRUT beneficiaries receive less than GRAT beneficiaries because a portion of the appreciation is shifted back to the grantor. Both GRATs and GRUTs are qualified annuity interests.

Conclusion
The GRAT is an excellent tool for transferring significant amounts of wealth and ensuring that it will be subject to little or no transfer tax. Care must be taken that the enabling document is properly drafted to ensure the expected tax treatment. With correct implementation, this planning technique can benefit both grantor and beneficiaries.

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Endnotes
1 All references in this article to “IRC” or “Code” refer to the Internal Revenue Code of 1986 as amended.
2 IRC §2704(c)(2).
3 Treasury Regulation §25.2702-3(b) and (d).
4 Treasury Regulation §25.2702-3(b)(1)(i).
5 Id.
6 IRC §7520.
7 IRC §1433.
8 IRC §2613(a).
9 Treasury Regulation 20.2036-1.
10 The mortality component is the assumption that the grantor could die during the term and that there always is the possibility of assets to transfer to the beneficiary, so the account could never zero out.
12 An annual return of 8 percent on the beginning-of-the-year balance is assumed in this example. Payments to Liz are assumed to occur at the end of each year. Year 1 interest totals $80,000 (or $1,000,000 x 8 percent), year 2 interest totals $75,722.21 (or $719,652.62 x 8 percent), and year 3 interest totals $33,350.20 (or $416,877.45 x 8 percent). Total interest for the three years is $170,922.41.