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A GRAT way to transfer wealth. Well, at least for now...

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If you possess assets that are appreciating fast (or at least you think they will), the GRAT is simply one of the most effective ways of transferring value at a low cost. The future of this technique is not clear, however, as proposed legislation could render it ineffective.

How the GRAT Works

A grantor retained annuity trust, or "GRAT," is a split-interest trust used to freeze an estate through the funding of appreciating assets. After the trust if funded, the trust then pays back an annuity to the grantor for a term of years, e.g., two to three years. The total value of these payments should approximately equal the total value of the assets transferred to the GRAT, growing at the appropriate interest rate, which is the I.R.C. § 7520 rate. Because the annuity is a qualified annuity interest under § 2702 of the Internal Revenue Code, the value of the annuity is subtracted from the value of the trust remainder, or the "gift." Due to the fact that the annuity payments are set up to roughly equal the value of the assets transferred to the trust, there should be little to no gift tax upon creation of the trust. Then, after the trust finishes making the annuity payments to the grantor, any assets remaining in the trust are passed on tax free to the donor's children, either directly or in trust. Also, by setting up the GRAT as a grantor trust, it is the grantor and not the GRAT that pays the tax on the trust's income, which further reduces the grantor's estate. The GRAT therefore provides an excellent opportunity to pass on massive amounts of wealth entirely free of gift tax.

What Goes Into the GRAT…

In order to be effective, the GRAT must be funded with assets expected to appreciate. When the annual annuity amount is calculated, the calculation is based on the fair market value ("FMV") of the assets transferred to the trust growing at the § 7520 rate as of the time of the transfer. Once the annual annuity amount is calculated it does not change. Therefore, it is recommended to transfer assets with a low value that are expected to appreciate dramatically in value. LLC and FLP interests make ideal candidates for funding a GRAT as minority LLC and FLP interests generally receive a discount for lack of marketability or control, which decreases their FMV and correspondingly the annuity amount. And if an asset that greatly increases in value funds the entity from which these interests derive, the difference between the annuity amount and the actual value of the interests could be substantial. That is the difference that would pass on to the children gift tax free. And to make this strategy more tempting, currently the § 7520 rate, also known as the "hurdle rate" for GRATS, is hovering at all-time lows.

…Must Come Out

GRAT annuity payments must be made at least annually and, as mentioned above, once the annuity payments are calculated, they cannot be changed. This does not mean though that the annuity payments must all be of equal value. As explained in the Treasury Regulations, the annuity may be increased or decreased, but any increase must be limited to a 20 percent increase over the amount in the prior year. Additionally, the annuity payment may be expressed in terms of dollar amounts or in terms of percentage (i.e., 50 percent of the trust assets for two years or 33 percent for three years).

There are multiple effective ways to make the annuity payments, which creates the flexibility needed to adapt to the various situations that may arise. If the assets held by the GRAT produce income, then the income could be used to pay the annuity. On the other hand, a portion of the assets transferred to the trust (or a fractional interest of the assets) may be distributed in payment of the annuity. It is also acceptable to sell a portion of the assets in the GRAT and then to transfer the necessary portion of the proceeds in payment of the annuity amount. If trust assets are sold, this sale will have income-tax consequences to the grantor even though the receipt of annuity payments does not. Another good way to provide for payment is to transfer cash into the GRAT with the assets that are expected to appreciate and then to make payments with the cash, thereby allowing the appreciating assets to remain in the GRAT untouched.

The Case of the Bad Assets

Because the annual annuity payments are based on the value of the assets at the time of the GRAT's funding and the § 7520 rate, the annual annuity payments are based on a fixed value. If these assets decrease in value over the term of the GRAT or if the assets do not grow at a rate equal to the § 7520 rate, then, at some point over the life of the GRAT, the GRAT will fail. If the GRAT fails, the assets still remaining in the trust are included in the grantor's estate. As the grantor was to be paid back with these assets over time anyway, this consequence is not so bad. Whether the grantor dies before the term ends, the GRAT fails, or the grantor lives to the end of the term and the annuity payments are completed, the grantor will end up with the same assets (or an equivalent) in his or her estate.

Thus, in reality, there are really only two negatives coming from an ineffective GRAT: the cost of creating the GRAT (i.e., the legal fees) and the inability to transfer value to the remainder beneficiaries. While the creation fees are unavoidable, the latter issue can often be remedied to an extent. When assets do not appreciate as hoped, the grantor can simply substitute these assets for assets of equal value that are expected to perform better. After the assets are substituted, the grantor can then take the original assets and re-GRAT them if so desired. The main limit for a substitution is that the substituted assets must be of equal value because once a GRAT is created additional assets cannot be funded into the GRAT.

To Be or Not to Be Trustee

As with every trust, one of the most important decisions is always regarding who should be trustee. With a GRAT, as a general rule, the grantor serves as trustee. Being that the value of the GRAT would be included in the grantor's estate if he died during the GRAT's term anyway, there is not an estate-planning risk for having the grantor also serve as trustee. But if the grantor outlives the GRAT and assets remain in trust for the grantor's children, the grantor should no longer remain as trustee as this could cause inclusion of the trust's assets in the grantor's estate and defeat the purpose of this wealth transfer technique.

Make It a Grantor Trust and Supersize the Benefits

By making a GRAT a grantor trust for federal income tax purposes, the grantor receives several benefits. First, the grantor will pay the tax on the trust's income and not the trust itself, thereby preserving the trust corpus. Second, if the trust is required to distribute appreciated assets in order to pay the annuity, the grantor will not recognize gain as the transaction is between the grantor trust and the grantor—a non-taxable event. Third, the grantor can assume various powers to increase his or her authority regarding the trust (i.e., the trust could provide the grantor with the power to substitute assets, the right to receive the greater of the trust income and the annuity payment, and a general power of appointment).

Rolling GRATs Lock in the Gain

One GRAT strategy that has picked up considerable steam in recent years is the use of rolling two-year GRATs. With this strategy the grantor first creates a two-year GRAT. Then at the end of the first year the grantor receives an annuity payment for 50 percent of the GRAT and immediately transfers this annuity payment into another two-year GRAT. The grantor then continuously proceeds to take the annuity payments received and transfer them into subsequent GRATs. This approach is beneficial because due to the short duration of each GRAT, if the assets appreciate they will almost always be distributed from the GRAT before much of the appreciation is lost, thereby locking in the gain for the benefit of the GRAT's remainder beneficiaries. Additionally, the short duration of each GRAT minimizes the negative effects should the grantor suffer an early death.

Insider Trading Rules

SEC rules generally restrict transfers of securities by company "insiders." These rules are extremely complex and a complete discussion of these rules is outside of the scope of this brief article. But generally "restricted securities" may be used to fund a GRAT without violating the rules of the SEC. A grantor's transfer of stock to the GRAT and subsequent annuity payments do not constitute a sale within the meaning of § 16 of the Securities and Exchange Act of 1934 and neither the transfer to or from the GRAT are reportable for § 16 purposes. However, as the indirect beneficial owner of company shares held by the GRAT, the grantor would be required to report on Form 4 any sale of shares by the GRAT. Also, the transfer of any remaining shares to the remainder beneficiaries at the end of the GRAT's term would be reportable on Form 5 as a gift. The GRAT would also have a separate § 16 reporting obligation if, as a result of its receipt of shares, it becomes greater than ten-percent shareholder.

Peering into the Crystal Ball

The practical effectiveness of a GRAT is in jeopardy due to two new rules being considered in Washington. The first possible change would be to require GRATs to last for a period of no shorter than 10 years. This rule would not completely destroy the GRAT as a wealth-transfer strategy, but it would cause strategies based on short-term GRATs, such as rolling GRATs, to become invalid. The other concern with the ten-year rule would be that it would cause GRATs to become less effective in passing on asset appreciation, given the natural fluctuation of assets. But being that the grantor could always pull out an appreciated asset and substitute another asset for it and then sell the appreciated asset to preserve the profit, this rule is not as dangerous as feared, though inconvenient.

The second rule that could undermine the effectiveness of GRATs is the requirement of a 10 percent remainder. This rule is much more likely to dissipate the use of GRATs as wealth-transfer strategies than the prior rule. It would make it extremely difficult for a GRAT succeed in shielding assets, as making the annual annuity payments would become quite difficult. Additionally, tax would have to be paid on the remainder (or some of the unified credit would have to be used). ■