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Goodnight GRAT

The requirement of a 10-year term and a remainder value greater than zero for GRATs as passed by the House in H.R. 4849 changes the utility of using it to transfer wealth.

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Written By:
Thomas R. Wechter

Grantor-retained annuity trusts — commonly referred to as "GRATs" — have been in the cross-hairs of the Internal Revenue Service (IRS), Congress and the Obama Administration for some time. This is because of the increased use of short-term GRATs with zero-remainder interests, resulting in no gift tax upon the creation of the GRAT. These GRATs have become known as zeroed-out GRATs. President Obama's 2010 and 2011 Budget Proposals proposed that a GRAT have a minimum term of 10 years. On March 24, 2010, the House passed the "Small Business and Infrastructure Jobs Tax Act of 2010 (H.R. 4849)," incorporating the Budget Proposals and two other restrictions on GRATs. On March 26th, 2010, the Act was referred to the Senate Finance Committee.

H.R. 4849

Section 307 of the Act — to take effect upon enactment — would impose a minimum term of 10 years, a residual value greater than zero and a prohibition of any decrease in the annuity payment during the first 10 years of a GRAT. The provisions dealing with GRATs enacted by the House spell the death knell for short-term, zeroed-out GRATs.

What Is a GRAT?

Sanctioned by Code Section 2702, GRATs allow a grantor to transfer the future appreciation of an asset to the grantor's family without a gift tax cost. Simply, a GRAT is the transfer of property by a grantor to an irrevocable trust with the grantor retaining the right to a fixed payment annually during the term of the GRAT. Upon the termination of the GRAT term, the assets of the trust pass — either in trust or outright — to the grantor's children.

Gift Tax Consequences

Under ordinary gift-tax rules, the initial transfer to the GRAT is treated as a taxable gift of the remainder interest, computed as the difference between the value of the property transferred to the GRAT and the present value of the annuity retained by the grantor. However, special rules apply in which a member of the grantor's family is a beneficiary of the remainder. Where a member of the grantor's family has an interest in the remainder, the present value of the annuity will be valued at zero, resulting in a taxable gift of the total value of the property transferred, unless the annuity retained by the grantor is a *qualified interest*. A *qualified interest* is generally the right to receive a fixed amount or a fixed percentage of the trust assets annually.

The present value of the annuity is computed using 120 percent of the applicable federal mid-term rate set forth in Code Section 7520 for the month in which the GRAT is established, commonly referred to as the *hurdle rate*. For the month of May, 2010, the hurdle rate is 3.45 percent.

Annuity payments cannot be paid by a note, but can be paid by a distribution of trust assets.

Zeroed-out GRATs

To avoid the gift-tax cost of implementing a GRAT, zeroed-out GRATs have become the planning technique of choice. A zeroed-out GRAT is structured so that the present value of the annuity is equal

to the value of the property transferred to the GRAT. As a result, the remainder interest is zero or very close to zero, resulting in no gift tax or a minimal gift tax.

If the GRAT does not outperform the hurdle rate, the grantor will receive back all of the property transferred as annuity distributions and will be in the same position as if the GRAT had never been created. Since all of the property transferred to the GRAT would have been distributed to the grantor, there would be no property left in the trust to pass on to the grantor's family. If a zeroed- out GRAT was not used, the grantor would have had to use up some of the grantor's lifetime gift-tax exemption or pay the gift tax on the value of the remainder when the GRAT was implemented. As a result, there would have been a gift tax cost to the grantor of using a non-zeroed-out GRAT.

H.R. 4849 requires that the remainder interest at the time of the transfer have "a value greater than zero" thereby ensuring a taxable gift and the filing of a gift-tax return from the creation of a GRAT. However, no amount is specified by which the remainder interest must exceed zero, so it may be possible that a minimal value would qualify with a minimal gift-tax cost. The final version of H.R. 4849 after Senate consideration may provide explicit requirements with respect to the value of the remainder interest or provide a minimum remainder interest requirement, similar to the provisions of Code Section 2701(a)(4) which requires that a junior equity interest in a corporation have a value of at least equal to 10 percent of all equity interests.

The Death of the Grantor During the GRAT Term

The grantor must survive the term of the GRAT for the intended benefit of the GRAT to be realized. Under an earlier IRS position, if the grantor did not survive the GRAT term, the GRAT property, including the appreciation, was includible in the grantor's estate, subject to estate tax. In June 2007, proposed regulations were issued under which only the portion of the GRAT assets necessary to produce the retained annuity without an invasion of principal was considered to be included in the grantor's estate, if the grantor did not survive the term of the GRAT.

As a result of the risk that the grantor would not survive the term of the GRAT, planners favored the use of the shortest term GRAT possible, e.g. two years. H.R. 4849 imposes a minimum 10-year term, which according to the House Ways and Means Committee Report is "designed to introduce additional downside risk to the use of GRATs." The minimum 10-year term for a GRAT would increase the likelihood that the grantor would die during the term of the GRAT and the GRAT would "fail."

No Decrease in Annuity Amount

The annuity amount must be a fixed amount expressed either in terms of a fixed-dollar amount or a fixed percentage of the fair market value of the GRAT assets. The fixed amount does not have to be same amount each year, but can vary from year to year in amount not in excess of 120 percent of the amount payable in the previous year. H.R. 4849 requires that the annuity payment cannot be reduced during the first 10 years of the GRAT. Consequently, the annuity payments cannot be structured to mirror the grantor's expectations of investment performance, as would be the case where the grantor anticipated a large increase in the value of the GRAT assets during the first year of the GRAT. In that

case the annuity payments would be structured to be higher in the first year and lower in the subsequent years.

Conclusion

For GRAT planning to be successful, GRAT assets must appreciate at a rate that exceeds the hurdle rate, the grantor must survive the GRAT term and no gift tax results from the creation of a GRAT. It is clear that H.R. 4849 is intended to make GRATs more costly in terms of a gift tax, but also more risky that the grantor will not survive the GRAT term. These new GRAT provisions would only apply to transfers made after the date of enactment, so there may still be time to create short-term, zeroed-out GRATs.

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