

Estate Planning with GRATs

By Arthur F. Bell, Jr., CPA, Arthur F. Bell, Jr. & Associates,
L.L.C.

It is said that the only sure things in life are death and taxes, but there is a lot that can be done to reduce taxes. Income taxes are very difficult to minimize, but gift and estate taxes can so easily be reduced that they are truly a voluntary tax only paid by those who do not take steps to plan their financial affairs.

Each individual's unique circumstances and wishes for disposition of their assets during and after their lifetime will determine the appropriate tax planning model to develop. One of the many tax planning tools available in certain circumstances is the use of a Grantor Retained Annuity Trust, which can be a very successful means to transfer assets free of gift and estate taxes.

Grantor Retained Annuity Trust (GRAT)

The Internal Revenue Code of 1986 (the Code), subsequent regulations and other sources of varying authority provide substantial basis to create a specific form of trust identified as a Grantor Retained Annuity Trust (GRAT), transfer assets to it in exchange for periodic payments and avoid gift and estate taxes on the excess (if any) of the earnings on the assets in excess of the stream of payments to the person transferring the assets. Simply stated, if an asset worth \$100 is placed in trust and the trust pays the transferor \$100, it is not surprising that no taxable gift occurs. If subsequent to the transfer, the \$100 asset experiences substantial earnings and appreciation in value, the benefit accrues to the trust and its beneficiaries and not the transferor. The \$100 paid to the transferor and any earnings it accumulates is still part of the transferor's estate and if such accumulated amount exceeds the amount in the trust after repayment of the \$100, no benefit results from the transfer. It is important to recognize that the success of the GRAT is dependent on earnings and appreciation in the GRAT in excess of the annuity payment.

The simplicity of transferring assets to a trust in exchange for an annuity is overshadowed by the complexity of the details involved in creating, implementing, administering and

distributing the assets upon termination of the GRAT. Determination of the annuity rate is governed by Code § 7520 and requires a multi-step equation. The rate changes each calendar month and the IRS publishes the required rate. Once the annuity rate is determined, it does not change thereafter. The April 2006 rate is 5.60%. Failure to satisfy the grantor's objectives in the trust agreement, non-compliance with any one of the many tax requirements, improper administration or inadequate disposition can have significant adverse consequences. State law must be taken into account in planning the terms of the GRAT. Most of these pitfalls can be avoided with competent professional planning and administration.

The GRAT agreement must have at least the following eight provisions:

1. The annuity payment must be paid at least once annually.
2. The annuity payment must not be paid by any form of debt instrument, however, the grantor or other sources could lend the trust the amount of the annuity in consideration of a commercial terms loan agreement.
3. The annuity payment must be a fixed or determinable amount such as a specific dollar amount or percentage. The amounts need not be the same each year, but must fall within defined requirements.
4. The trust must allow adjustment of the annual payment under certain circumstances.
5. The trust documents must prohibit any additional contributions to the trust after initial funding.
6. The trust may not pre-pay the annuity.
7. The trust may not make payments to other persons during the annuity payment period.
8. The term of the annuity must be established in the trust agreement.

The following discussion expands on these provisions, but this memo is not intended to cover all possibilities, conditions, variations and exceptions to the basic GRAT rules, and thus should be read only as illustrative and not definitive for all possible circumstances.

A GRAT must be an irrevocable trust such that once the trust is drafted in final form, signed and funded with even a token

amount, the trust terms may not be modified. If a grantor desires a different structure from the initially created trust, a new trust with desired terms may be created but the initial trust remains until it is terminated pursuant to its terms. Some states allow trusts subject to their jurisdiction to change terms provided that the trustee, the grantor and all beneficiaries agree on the change in writing. The tax consequences of such an agreed change may be adverse, so any desire to change must be carefully analyzed.

Decisions must be made on the term of the GRAT taking into account income, mortality and tax risks. One of the conditions of a GRAT is that the trust must pay an annuity based on the value of the asset transferred to the GRAT. If the GRAT fails to earn sufficient amounts to satisfy the payments, portions of the principal or asset contributed may be valued and used to make a payment in kind, i.e. in shares of a company.

The payments may not be less frequent than annual and may be structured so that the initial payments are lower and the final payments higher. The increasing payment plan allows the GRAT lower payments to start out and to ideally accumulate excess earnings in the early periods to satisfy the subsequent larger payments. Financial factors to consider in selecting a GRAT term include (i)

the frequency of the payments if less than annual, (ii) the amount of the payments, (iii) the term of the GRAT and (iv) the minimum interest rate as determined by the IRS that must be adopted in setting the annuity. There are some provisions that can be employed if the trust has insufficient funds to pay the annuity and does not wish to return assets, but such alternatives are short-term solutions and may not be available in all circumstances.

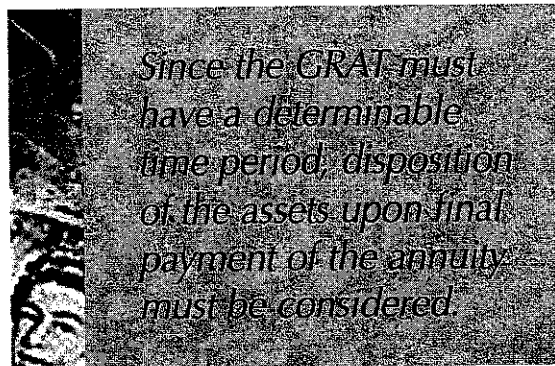
A longer term may be attractive in allowing more time to comfortably pay an annuity, but if the grantor dies during the period of the GRAT, some or all of the GRAT assets may be included in the deceased's estate thereby reducing the benefit of the GRAT. And, the longer the GRAT term, the longer the delay in passing assets to the desired beneficiaries. If the grantor and intended beneficiaries of the GRAT's assets are young, a longer-term GRAT has the advantage; the further the

grantor is away from this status, the more attractive a shorter-term GRAT becomes. Other factors can also be important in selecting the term. The IRS does not directly prescribe a minimum or maximum GRAT duration, but does require that a GRAT have a definite period equal to the life of the grantor, a specified period of years or a term that is the lesser of the life of the grantor or time certain. Multiple successive GRATs may be created if the facts support such a plan whereby instead of one ten-year GRAT, five successive two-year GRATs are established. The advantage of the short-term GRAT is that the grantor's survival risk is minimized and possibly the financial risk is lessened if the near term is more certain and future years income are in doubt. A risk of the series of short-term GRATs is the potential tax law changes with detrimental consequences to GRATs established after the date of the enactment of the change. Longer-term GRATs delay dispo-

sition of assets to beneficiaries and may have a greater default or administration risk. I typically see three to five year terms for GRATs, but the term is highly fact dependent.

Since the GRAT must have a determinable time period, disposition of the assets upon final payment of the annuity must be considered. It is possible that the GRAT could continue to hold the assets and

include terms for ultimate disposition, but such treatment limits the flexibility of the trust if the terms of a single trust must satisfy both the requirements of a GRAT and the wishes of the grantor regarding post-GRAT administration and disposition. Thus, the most common structure is for the GRAT to dispose of all assets remaining after payment of the annuity into a specific trust or multiple trusts created simultaneously with the GRAT but potentially unfunded until the maturity and termination of the GRAT. This new trust may have the full range of possible terms and beneficiaries, although the grantor would not be a beneficiary as such a condition might recoup assets into his estate. Often a spouse is included even though unlimited gifts could be made to a qualifying spouse without the use of a GRAT. The reason for including the spouse as a beneficiary of the residual trust is to make the



assets in the GRAT available for the spouse if desired at some future date. Many years after the creation of the GRAT the grantor and spouse may have suffered adverse financial circumstances and want access to a possibly over generously funded GRAT and inclusion of the spouse would at least make the spouse an eligible beneficiary. Suffice to say that the attention given to the residuary trust is of equal importance to the terms of the GRAT.

The purpose of this article was to provide a general overview of the estate planning tool of using GRATs. Due to the intricacies inherent to the GRATs, such as gift tax returns, annual tax returns, and generation-skipping tax implications, you

should consult an experienced tax advisor, as well as an experienced attorney to properly form the GRAT.

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