Published in the 2010 Campbell Law Observer,
October 2010 Volume 31, Number 5

ZERO LOVE FOR "ZEROED" GRATS

H.R. 4849, also known by its short title, the "Small Business and Infrastructure Jobs Tax Act of 2010", has a revenue provision that does not seem to have much to do with small business or infrastructure. Section 307 of the bill makes three big changes to I.R.C. 2702 to end a wealth transfer technique that has worked well for legally avoiding the gift tax.

BACKGROUND

First some background. A GRAT is a Grantor Retained Annuity Trust. The mechanics of the GRAT are: A trust is set up. The trust is funded with a large investment. The trust pays like an annuity: it pays the grantor annual payments for a fixed period of time. At the end of the annuity term, the remaining value in trust is passed on to the beneficiaries. The beneficiaries must be family members to the grantor. If the grantor dies during the term of the trust, the value of the trust is passed on the beneficiaries but it also likely to be included in the estate of the grantor.

THE GRAT APPLIED

IRC § 2702 provides a formula for gift valuation: (Value of property transferred) - (value of any qualified interest retained by the grantor) = value of gift. What make the GRAT work is that the gift is valued at the time the trust is funded and the annuity payments begin. The gift value is set equal to the initial contribution to the GRAT plus a hypothetical interest rate earned on the principal minus the annuity payments that would be made through the end of the term. This hypothetical interest rate is determined by IRS regulations (it is the 7520 rate[1]). This rate is set during the month that the GRAT is established. Because the benchmark interest rate to beat is at a historic low (around 3%) it is easy for a GRAT to become a winner.

To "zero" the GRAT, the sum of the scheduled annuity payments of a GRAT is set to be about equal to the principal plus the hypothetical interest rate. Thus, for tax purposes, the initially calculated gift value is zero, since what will be paid back to the grantor in annuity payments should be about equal to what the grantor invested, plus interest.

Like any gift the tax is computed when the transfer is made, subsequent appreciation is ignored. Smart investors load up the GRAT with highly volatile assets (ignoring diversification), and sell off the winner investments to lock in gain into the GRAT. Any super appreciating asset is also placed in the GRAT. This insures the interest is earned

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[1] The interest rate used to compute the amount of a taxable gift to a GRAT is called the IRC §7520 rate. It is 120% of the federal mid-term rate in effect at the time of the gift. This is computed by using an interest rate (rounded to the nearest 2/10th of 1 percent) equal to 120 percent fo the federal mid-term rate in effect under §1274(d)(1) for the month in which the valuation date falls.

higher than the hypothetical IRS interest rate. How does this math work out so dramatically in favor of the GRAT, as compared to an outright gift? The grantor of the GRAT draws from the annuity as if the principal were only growing at the hypothetical IRS interest rate, and in a successful GRAT, compounding occurs greater than the assumed IRS interest rate. The effects of this compounding are leveraged because the compounding principle works on all the money even as annuity payments are drawn out. Thus at the end of the term, the value remaining in the GRAT may still be large, even though the initial IRS calculation suggests that it should have been zero. This remaining value is then passed on to the beneficiary without incurring a gift tax. The grantor can still use his or her one million unified gift tax credit on other transfers.

One of the biggest risks in the GRAT business is that the grantor will die before the end of the term. Currently, if the grantor dies during the GRAT term, the GRAT, or a portion of it, is included in the grantor's estate[2], meaning that the grantor loses the time value of any gift tax paid, and otherwise derives little or no estate tax benefits from the technique. A healthy grantor has a greater likelihood of getting the most out of a GRAT, obviously, since the healthier the grantor, the more likely the grantor will outlive the term. The likelihood of death within the term can be mitigated by using a two year GRAT followed by re-GRATing for another two year term. Two years is the shortest term allowable. Term life insurance can also be employed to mitigate the risks. The two year annuity was used in Walton v. Commissioner, 115 T.C. 589 (2000), a landmark case where the Tax Court rejected the IRS's arguments and put the GRAT on a sure footing.

THE PROPOSED CHANGES

The proposed changes to the law play to the risks you are trying to avoid. Here are the three requirements.

- The annuity payments must be set up for a term of not less than 10 years.
- The fixed amounts, when determined on an annual basis, do not decrease relative to any prior year during the first 10 years (the required term).
- The remainder interest must have a value greater than zero at the time of the transfer.

The ten year requirement substantially increases the mortality risk of using the GRAT technique. For people in bad health, this law, if enacted, effectively eliminates the GRAT from the estate planning toolbox. GRATs will be increasingly paired with term life insurance held in irrevocable life insurance trusts. If the client dies before the 10 year period ends all GRAT assets are in the client's estate and the term insurance will be used to pay the tax. But this is no win-win, the 10 year requirement eliminated the untaxed gain the client was after and all the client did was plan for and pay the estate tax[3].

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[2] If the grantor fails to survive the term, either all of the GRAT is included in the estate of the grantor under IRC §2039, or a portion of it is included under §2036.

[3] We are in the repeal year under the Economic, Growth and Taxpayer Relief Reconciliation Act of 2001 (EGTRRA). Unless modified by Congress, EGTERRA §901(b) states pre-EGTRRA law will govern decedent's estates in 2011 and future years.

The “fixed amounts” requirement works alongside the 10 year requirement. This requirement eliminates decreasing fixed amounts[4]. This requirement will prevent an end run around the 10 year rule. If you sufficiently front loaded all the GRAT payments in the first two years, the final eight years would not have much impact. Without this requirement, clever tax attorneys would create 10 year GRATs with the economic impact of two year GRATs Congress is trying to do away with.

The “greater than zero” requirement might be attempting to create a reporting requirement. Many tax advisors had been structuring GRATS with a modest gift so it could be reported on a gift tax return. Sending a return would create some certainty with regard to the look back period for an audit.

CONCLUSION

As the Obama Administration and Congress look for ways to increase revenue, they are going to pass laws that take a bigger bite into the wealth transfer techniques. The only good news is this bill, if it becomes law, will have application on GRATS created after the date of enactment. Now is a good time to set up a GRAT.

[4] Treas. Reg. §25.2702-3(e), Ex.(3) currently allows decreasing annuity payments.