HAWTHORN INSTITUTE

A center of excellence building bridges from thought to action, creating practical, applicable strategies to help benefit you and your family

An Overview of GRATs as a Wealth Transfer Tool

A Grantor Retained Annuity Trust is a wealth transfer tool that can facilitate and advance a family's objectives and legacy by providing opportunities for tax-free, low-risk transfers of wealth. A GRAT can also provide an effective vehicle for succession of a closely held business.

Wealthy individuals typically seek straightforward, low-risk wealth transfer tools that can help mitigate or eliminate substantial taxation of a family or even a family business. At Hawthorn, we view a Grantor Retained Annuity Trust (GRAT) as one such wealth transfer tool that can provide a host of benefits for wealthy individuals, with minimal downside risk.

GRATs have several advantages, including:

- GRATs can be structured such that no taxable gift or corresponding gift tax liability results from the ultimate transfer of assets to family members.
- They can be structured to have minimal downside risk other than any applicable legal and administrative costs.
- If the valuation of assets transferred to a GRAT is successfully challenged by the Internal Revenue Service (IRS), an automatic adjustment can prevent any adverse gift tax consequences.
- As a grantor trust during the annuity term of the GRAT, the transferor can swap assets with the GRAT without income tax or capital gains consequences, providing opportunities to further leverage the wealth transfer effectiveness of the GRAT.
- The potential wealth transfer opportunity is magnified in a low-interest-rate environment.
- GRATs are sanctioned by the Internal Revenue Code (IRC).

We believe GRATs represent a beneficial tool for facilitating and advancing a family's objectives and desired legacy by providing opportunities for substantial tax-free, low-risk transfers of wealth. Such transfers can be made in further trust to better implement a family's overall multigenerational vision and succession plan.

Also, GRATs can provide an effective vehicle for succession of a closely held business, allowing the transferor to remove substantial value from his taxable estate without taxation or significant risk while retaining control over the business.

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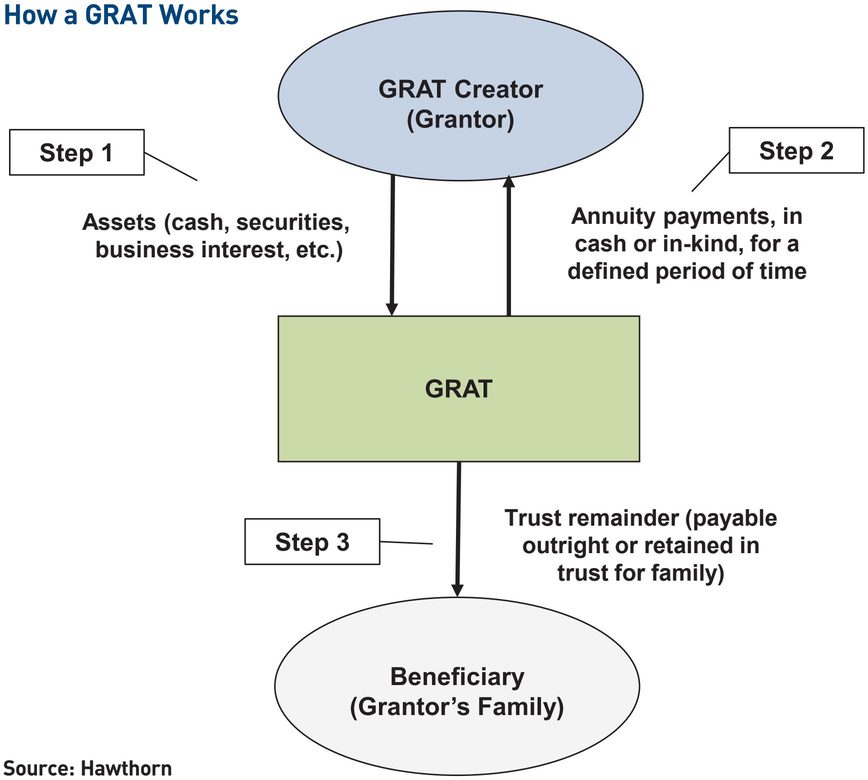
GRATs are a primary wealth planning option that should be seriously considered when preparing and implementing a family or closely held business succession plan.

The Mechanics of GRATs

A GRAT, governed by IRC Section 2702, is an irrevocable trust to which the grantor transfers assets in exchange for a fixed payment, or annuity, for a term of years chosen by the grantor. The term is typically measured by a fixed number of years, but it may also be measured by the grantor's life or the shorter (but not longer) of a fixed number of years or grantor's life.[1] Upon completion of the annuity payment term, the GRAT's remaining assets pass to the beneficiaries, either outright or in further trust. Figure 1 illustrates how a basic GRAT works.

Figure 1

How a GRAT Works



Source: Hawthorn

Lineal descendants, the typical intended remainder beneficiaries of this wealth transfer vehicle, are considered family members under the IRC.[2] Therefore, the retained annuity must satisfy the definition of "qualified interest" under IRC Section 2702(b) in order to be given a value that can reduce the taxable gift attributable to the transfer.

Annuity Payments

To be a qualified interest, the annuity payable under a GRAT must be either a fixed dollar amount or a fixed percentage of the initial fair market value of the property as finally determined for federal tax purposes.[3] No additional contributions to the trust are permitted.[4]

1 Treasury Regulation (Treas. Reg.) Section 25.2702-3(d)(4).
2 IRC Sections 2702(a)(1) and (e).
3 IRC Section 2702(b)(1) and Treas. Reg. Section 25.2702-3(b)(1)(ii).
4 IRC Section 2702(b)(1) and Treas. Reg. Section 25.2702-3(b)(4).

This annuity payment term can be as short as two years. Also, the annuity can be structured such that the payments increase as much as 20% over the preceding year's amount at any time during the annuity term. Only the grantor can receive annuity distributions during the annuity term.[5]

The annuity payments must be made at least annually. A pro-rated annuity amount is required for any short year of the GRAT (such as in the year it was created or the year of the final annuity payment). The entire annuity amount must be paid each year from income or from principal, if income is insufficient. The annuity can be paid as late as 105 days after the anniversary of the GRAT's creation each year, and no later than the date for filing the GRAT's income tax return (not counting extensions) if the required annuity amount is based on the taxable year of the trust.[6] The required payments cannot be "commuted" (prepaid) to the grantor.[7]

Grantor Trust Status

A GRAT is treated as a grantor trust for federal income tax purposes under IRC Section 673 (grantor's retention of a 5% or greater actuarial reversionary interest in the GRAT determined at the time of the trust's creation) or IRC Section 677 (retention of income interest), or both. At its inception, the value of the retained annuity interest in a GRAT will typically be worth more than 5% of the value of the trust assets. In that case, IRC Section 673 would apply to make it a grantor trust for income tax purposes. In addition, although the retained annuity is a fixed payment, those payments necessarily encompass the income of the trust (and as necessary, principal), causing IRC Section 677 to apply as well.

As a grantor trust, all tax items such as income and capital gain realized by the GRAT during the annuity term will be taxed to the grantor on her personal income tax return. Since the grantor is considered the owner of the trust assets for income tax purposes, the actual annuity distributions will not be taxable to the grantor because the passing of assets between grantor and grantor trust for any reason does not constitute a taxable event.

The grantor's payment of income tax with respect to tax items of the GRAT as a result of its grantor trust status is not considered a gift by the grantor to the GRAT remainder beneficiaries.[8] Accordingly, the GRAT assets grow for the remainder beneficiaries unencumbered by federal income tax and capital gains tax without adverse gift tax consequences. Most states follow federal grantor trust status for state income tax purposes as well (Pennsylvania is an exception).

As a grantor trust, the transferor's initial contribution of assets to the GRAT, even of appreciated assets, will not result in any income tax or capital gains tax consequences. In addition, IRC Section 2702 does not prohibit the transferor from exchanging assets of equal value for assets of the GRAT. Such exchanges will not create federal income tax or capital gains tax consequences during the annuity term when the trust is treated as a grantor trust. For example, during the annuity term, the transferor could "purchase" assets of the GRAT for their equivalent value in cash.

5 Treas. Reg. Section 25.2702-3(d)(2).
6 Treas. Reg. Section 25.2702-3(b)(5).
7 Treas. Reg. Section 25.2702-3(d)(5).
8 Under Rev. Ruling 2004-64, 2004-2 C.B. 7.

Along these lines, distributions of the required annuity amount can be made in cash or in kind (or both), without any income tax consequences to the GRAT or the transferor. However, the GRAT trustee cannot satisfy the required annuity payment by issuing a promissory note to the grantor.[9]

Upon termination of the GRAT, the remaining assets pass to the remainder beneficiaries, who can be individuals or trusts. Assets originally transferred to the GRAT maintain the grantor's income tax basis in the trust, and this basis carries over to the remainder beneficiaries if it is received as part of the trust's remaining assets. Carryover basis occurs because these assets were not subject to capital gains taxation when contributed to the trust.[10]

As a grantor trust, the GRAT will not be treated as a separate stockholder or as a nonqualified trust for S Corporation eligibility purposes.[11] Therefore, S Corporation stock can be readily transferred to a GRAT.

Valuing the Gift

The value of the fixed annuity retained by the transferor is subtracted from the value of the assets transferred to the GRAT in determining the value of the gift to the remainder beneficiaries at the end of the annuity term for federal gift tax purposes. This remainder interest is a taxable gift, potentially subject to gift tax in the year the GRAT is created. We believe the reduction of the value of the grantor's retained annuity in determining the gift amount attributable to the remainder interest passing to beneficiaries is key to accomplishing effective, leveraged wealth transfer through the utilization of GRATs.

If the annuity amount and term are high enough or long enough, or both, the value of the grantor's retained annuity for gift tax purposes could equal 100% of the value of the assets transferred. Thus, when subtracting this retained annuity value from the value of the assets transferred to the GRAT, the resulting gift is zero. This type of a GRAT is known as a Zeroed Out GRAT.

The gift of the remainder interest is not a present interest because it cannot be enjoyed by the remainder beneficiaries until the end of the transferor's retained annuity term. Consequently, the annual gift tax exclusion, which only applies to gifts of present interests, cannot be applied to reduce or eliminate the tax liability associated with this amount. Instead, the amount of the gift attributable to the GRAT remainder interest reduces any remaining lifetime gift exclusion of the transferor, and any balance of the gift amount will result in actual gift tax liability.

The value of the retained annuity is calculated in the month of the gift based on the prevailing applicable interest rate for this purpose determined under IRC Section 7520 and published monthly by the IRS. This Section 7520 rate fluctuates in direct relation to changes in interest rates on U.S. Treasury obligations.

As the Section 7520 rate decreases, the value of the grantor's retained interest (which is subtracted from the value of the transferred assets in determining

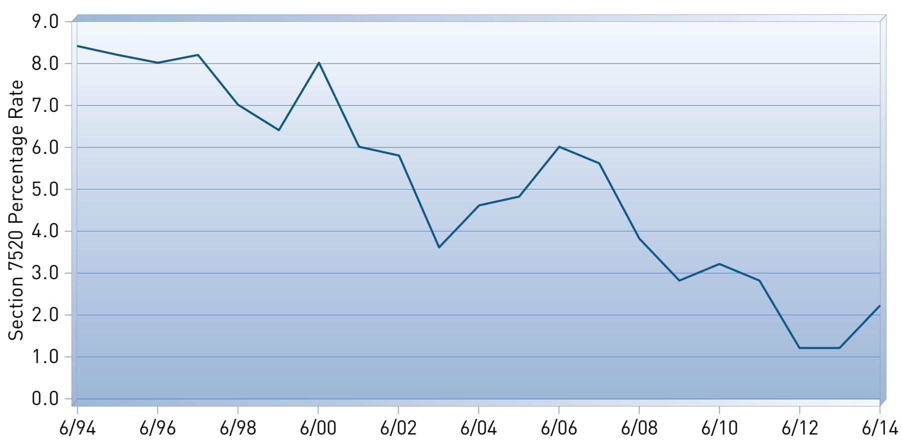
9 Treas. Reg. Section 25.2702-3(b)(1)(i).
10 IRC Section 1015.
11 IRC Section 1361(c)(2)(A)(i).

the value of the gift of the remainder interest) increases; as the Section 7520 rate increases, the value of the grantor's retained interest decreases.

For example, at the August 2014 Section 7520 rate of 2.2%, a 10-year GRAT paying 10% of the initial value of the assets transferred will produce a retained interest value of 88.89% of the assets transferred. Consequently, a transfer of $1 million to such a GRAT in that month would result in a taxable remainder interest gift of only 11.11% of that amount, or $111,100. If, however, the Section 7520 rate increased to 5.2%, the value of the retained annuity for the same GRAT would fall to 76.47% of the contributed assets, resulting in a taxable gift of 23.53%, or $235,300. At a Section 7520 rate of 8.2%, the retained annuity value drops to 66.5% and a resulting gift of $335,000, more than three times the gift based on the current Section 7520 rate.

Accordingly, a lower interest rate environment generally makes GRATs more attractive (Chart 1).

Chart1
History of Section 7520 Rate, 1994-2014



Source: Hawthorn

The Section 7520 rate is equal to 120% of the midterm applicable federal interest rate for intrafamily loans determined under IRC Section 1274, rounded to the nearest .20%. The Section 7520 rate for August 2014 was 2.2%. Generally, if the overall investment rate of return on the GRAT assets exceeds the Section 7520 rate used in determining the required annuity amount and corresponding projected remainder amount, the GRAT will generally be successful because assets in excess of the actuarially projected remainder amount (which is the measure of the gift amount) will be passing to the beneficiaries. Consequently, the Section 7520 rate is often referred to as the hurdle rate because it represents the threshold for a rate of return on the GRAT assets that will result in a successful wealth transfer.

Concerns

While there are significant benefits associated with a GRAT, careful planning is also needed to avoid what we think are some potential pitfalls.

Mortality Risk – Estate Tax Inclusion

If the transferor dies during the term of the required annuity payments, then all or a portion of the GRAT assets will be includible in his taxable estate.[12] The estate would include assets of a trust to which a grantor has made a transfer while retaining a right to income from that trust which has not ended at the time of death. Although the retained interest is an annuity rather than specifically income, the IRS specifically treats the retained annuity as constituting the retention of the right to income for purposes of IRC Section 2036(a)(1).[13] IRC Section 2039, which generally includes the value of annuities held at death, can be excluded as a mechanism for estate inclusion; retaining an interest in an annuity from a trust is not encompassed by IRC Section 2039.[14]

Although some advisors might assert that all of the assets of a GRAT are always includible in the taxable estate should the grantor die prior to the end of the annuity term, only the portion of the GRAT assets necessary to provide the annuity payment without reducing or invading principal are includible in the decedent's taxable estate.[15] Example 2 in Treasury Regulation Section 20.2036-1(c)(2)(iv) provides that the includible amount is calculated by dividing the annuity amount by the Section 7520 rate in effect on the grantor's date of death. This formula must be used regardless of when the grantor dies during the retained annuity term. In many situations, this formula may nevertheless cause all of the assets of the GRAT to be included in the grantor's taxable estate.

For example, assume a grantor establishes a GRAT in August 2014 by transferring $1 million and retaining an annual annuity of $137,690 for eight years based on the 2.2% Section 7520 rate. After receiving six annual annuity payments but prior to receipt of the last two years' annuity payments, the grantor dies. If the Section 7520 rate at the time of the grantor's death has increased to 4.0%, the amount of the GRAT assets includible in the grantor's estate would equal $137,690 (the annual annuity payment) divided by .04 (Section 7520 rate at death), or $3,442,250. Unless the annual investment return on the assets, net of the annuity payments, was at least 32%, this figure would equal or exceed the value of the GRAT assets at that time. Thus, all of the GRAT assets would be included in the grantor's taxable estate.

Consequently, the transferor's age, health, related factors, and general risk of death in any year should be taken into account in determining the length of the retained annuity term. The shorter the term selected, the higher the corresponding required annual annuity payment to accomplish the same actuarial value of the retained annuity in determining the value of the remainder for federal gift tax purposes.

12 IRC Section 2036(a)(1).
13 Treas. Reg. Section 20.2036-1(c)(2).
14 Provided for under Treas. Reg. Section 20.2039-1(e).
15 Treas. Reg. Section 20.2036-1(c)(2).

Valuation Issues

IRC Section 2702 contains the specific requirements for GRATs as outlined above. As long as these requirements are contained in the GRAT document and adhered to in its administration, there is generally no risk of IRS challenge to the GRAT itself. However, a potential challenge is proper valuation of the assets transferred to the GRAT.

For example, if a grantor intends to create a Zeroed Out GRAT and transfers assets she values at $1 million, a specific corresponding annuity amount would be set based on the Section 7520 rate in the month of the GRAT's creation and the selected length of the annuity term. If, however, the IRS values those assets at $1.5 million, the annuity amount would have been required to be 50% higher each year in order to "zero out" the GRAT and eliminate any taxable gift amount attributable to the projected remainder interest. As a result, the deficient annuity amount would result in a taxable gift for federal gift tax purposes. Treasury Regulation Section 25.2702-3(b)(2), however, allows for an automatic adjustment upward of the required annuity amount in such cases so that no adverse unintended federal gift tax consequences result. Of course, the increased annuity amount will ultimately reduce the amount of the remaining assets passing to or for the remainder beneficiaries.

Generation Skipping Tax Issues

The Generation Skipping Transfer (GST) tax applies to transfers to "skip persons," which generally include grandchildren or subsequent generations of the transferor, or trusts for such individuals. The GST tax applies to gifts or bequests in addition to any gift tax or estate tax liability at a rate of 40%. A GST tax exemption equal to the lifetime exclusion (currently $5.34 million per person, indexed for inflation) is available to cover such transfers. If GST tax exemption is allocated to all of the assets of a trust, then the assets of that trust and their future appreciation can be entirely exempt from GST for the trust's duration. This would apply as long as no subsequent gifts or bequests are made to the trust that are not covered by additional allocation of GST tax exemption. (For more on the GST tax, see the June 2013 Hawthorn white paper, *The Family Opportunity Trust, Part II: Leveraging the Trust.)*

One limitation on the wealth transfer potential of GRATs is the estate tax inclusion period (ETIP) rule applicable to GRATs under IRC Section 2642(f). Under this provision, a transferor's GST tax exemption cannot be allocated to the remainder interest in the GRAT while assets of the GRAT are includible in the transferor's taxable estate under IRC Section 2036. Accordingly, GST tax exemption cannot generally be applied to the GRAT remainder interest until the close of the transferor's retained annuity term. The full amount of the actual remaining assets of the GRAT at the end of the annuity term would be subject to GST tax and require allocation of GST exemption to that amount in order to avoid such tax, if the remainder passes to or for GST-taxable beneficiaries such as grandchildren.

As an example, assume $1 million is transferred to a Zeroed Out GRAT. At the close of the grantor's retained annuity term, $500,000 of assets remain. The measure of the taxable gift for federal gift tax purposes is zero because the value of the gift for this purpose is determined at the creation of the GRAT when the actuarially projected gift of the remainder interest is zero. For GST tax purposes, however, the amount subject to GST tax, and thus requiring allocation of GST tax exemption to avoid imposition of GST tax, is $500,000, the actual value of the assets at the close of the annuity term.

Although there is generally no leverage or benefit to utilizing GST tax exemption with GRATs, there are potential work-arounds to allow for effective generation-skipping planning for GRATs. These are discussed in the Hawthorn Institute paper, *Optimizing GRATs*.

Note that a grandchild or grandchildren could be the remainder beneficiaries of a GRAT without GST tax concern or need for GST tax exemption allocation when the grantor's child, who is parent of the subject grandchild or grandchildren, is deceased at the time the GRAT is created. This IRC provision treating such grandchildren as being only one generation removed from the transferor (that is, taking the place of their deceased parent), and thus not a skip person for GST tax purposes, is known as the predeceased parent exception.[16]

Reimbursement of Grantor for Income Taxes

For flexibility purposes, grantors often request that the GRAT trustee have the authority to reimburse the grantor for income taxes attributable to the tax items of the GRAT that pass to the grantor's personal income tax return, based on the GRAT's grantor trust status for income tax purposes.

Treasury Regulation Section 20.2036-1(b)(2) treats availability of trust assets to discharge a legal obligation of the decedent (such as debts, including taxes) as a retained right to enjoyment of the property causing inclusion of the assets of the trust in decedent's taxable estate. Revenue Ruling 2004-64, however, states that the grantor's mere retention of a discretionary beneficial interest alone is not sufficient to cause estate inclusion under IRC Section 2036(a)(1) if the grantor's creditors cannot be satisfied from the trust assets, as long as

- there is no understanding or arrangement between the grantor and trustee regarding the exercise of discretion for the grantor, and
- the grantor does not retain the power to remove and replace the trustee.

We do have one concern, however. Revenue Ruling 2004-64 also held that if either the trust document or state law required (rather than permitted in the trustee's discretion) that the grantor be reimbursed for tax paid on behalf of the trust, then

16 IRC Section 2651(e).

this would constitute the right to have trust property used to discharge a legal obligation of the grantor. This could cause inclusion of the trust assets in his taxable estate.[17] While a GRAT document can readily be drafted to permit but not require the trust to reimburse the grantor for taxes paid with respect to the trust to avoid this aspect of the ruling, the provisions of state law on this issue cannot be controlled.

Along these lines, there is a question whether the law of some states (such as Pennsylvania) requires a trust to reimburse the grantor for taxes she pays on behalf of the trust.[18] New York, on the other hand, provides specifically by statute that a creditor of a grantor cannot reach trust assets based solely on the trustee's discretionary power to reimburse the grantor for tax liability with respect to income of the trust.[19] Delaware law is equally clear on this point. Ideally, including a reimbursement provision would occur if governing state law was clear, such as in New York or Delaware, that the discretionary reimbursement provision would not cause inclusion of the assets in the grantor's taxable estate.

Federal Proposals Affecting GRATs

The 2015 federal budget, consistent with prior years' budgets, proposes the following provisions to restrict GRATs:

- a minimum annuity term of 10 years;
- decreases in the annuity amount during the GRAT term prohibited; and
- a requirement that the actuarial remainder at the outset of the GRAT be greater than zero.

The last proposal above would eliminate Zeroed Out GRATs. Neither the 2015 budget nor any previous budget, however, states the amount or percentage by which the minimum required projected remainder would have to exceed zero. One dollar is greater than zero; accordingly, without some required minimum remainder, Zeroed Out GRATs would remain viable as a practical matter. Perhaps if this proposal is taken up by Congress, we believe the bill could propose some actual threshold minimum actuarial remainder amount. A possible minimum might be 10% of the initial value of the GRAT assets, which is consistent with the requirement for Charitable Remainder Trusts.

In our opinion, the elimination of Zeroed Out GRATs in some significant sense (such as through a 10% minimum remainder requirement) and the elimination of GRATs with terms shorter than 10 years would dramatically and negatively affect the utility of GRATs and several of the methods for optimizing them discussed above.

Any or all of these proposals, if enacted, would, pursuant to the budget proposal, take effect for GRATs created after the date of their enactment.

17 This aspect of the ruling was based on IRC Section 2036(a)(1).
18 See *French Trust,* 23 Fiduciary Reporter 296 (Philadelphia County Orphans Court 1963) and *Mathay Trust,* 1 Fiduciary Reporter 2d 96 (Montgomery County Orphans Court 1981) regarding Pennsylvania law on this issue.
19 New York Estates, Powers and Trusts Law Section 7-3.1(d).

In addition, the 2015 budget would generally treat the portion of assets in a trust received in a "swap" transaction between a grantor and a trust that is a grantor trust for income tax purposes with respect to the grantor, as subject to federal gift or estate tax. This proposal, which would be effective for such transactions after the date of its enactment into law, would further erode some of the planning opportunities available with GRATs, and GRAT remainder interests, as described above.

The possibility of these proposed changes places some sense of urgency upon establishing GRATs for individuals and families where such a wealth transfer strategy and related planning opportunities fit their planning objectives.

Conclusion

We believe GRATs represent a minimal-risk wealth transfer tool with the potential for substantial reduction of one's taxable estate with little or no gift tax liability or use of lifetime gift exclusion. In addition, the current low-interest-rate environment generally favors GRATs, making them more effective than when higher interest rates are in effect.

The substantial benefits, without detriments, of GRATs as provided for in the Internal Revenue Code have made them a target for adverse legislative changes. Accordingly, individuals seeking to engage in family wealth transfer should consider and perhaps implement a GRAT or GRATs in the near term.

Several related strategies exist for further leveraging wealth transfer with GRATs. These strategies are examined in the Hawthorn Institute paper *Optimizing GRATs*.

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September 2014