Vol P. 3235-3236 FRIDAY, JUNE 7, 2013 THE LEGAL INTELLIGENCER

Reprinted with permission from the June 7, 2013 issue of The Legal Intelligencer © 2013 ALM Media Properties, LLC

TRUSTS AND ESTATES

Why It's a Great Time for Estate Planning With GRATs

BY REBECCA ROSENBERGER SMOLEN AND AMY NEIFELD SHKEDY
Special to the Legal

As interest rates continue to be at historical lows, there are fleeting opportunities to engage in particularly effective estate planning techniques. One estate planning strategy that benefits from low interest rates is a GRAT.

THE BASICS

A GRAT, which stands for "grantor retained annuity trust," is created when an individual (the grantor) transfers assets into an irrevocable trust and retains the right to a series of annuity payments for a fixed term of years. After the annuity term, any balance remaining in the GRAT is transferred to (or held in further trust for) the family members who are named as the remainder beneficiaries. The initial transfer of the property to the GRAT is a gift for gift tax purposes; however, the value of the gift is reduced by the present value of the grantor's retained annuity interest. A lower interest rate increases the value of the retained annuity and, thus, reduces the overall value of the gift of the remainder. In fact, GRATs are often "zeroed out" so that the remainder interest (i.e., the gifted amount) is effectively equal to zero and no gift tax is payable, although President Obama's fiscal 2014 revenue proposals seek to require GRATs to have a remainder interest greater than zero. A successful GRAT will have the result of shifting the growth and appreciation of the transferred property to family members at no or minimal gift tax cost.

GRATs perform better when the interest rate is lower. The applicable interest rate for a GRAT is the Section 7520 rate, which is published by the IRS each month. The Section 7520 rate for the month of June is a mere 1.2 percent. As stated above, this rate is used to calculate the present value of the grantor's retained annuity. To the extent that the assets in the GRAT outperform the Section 7520 "hurdle" rate, all of that surplus growth and appreciation inures to the benefit of the grantor's named heirs. On the other hand, if the growth of the assets in the GRAT does not outperform the hurdle rate, so that all of the assets come back to the grantor in the form of an annuity, leaving no remainder for the heirs, the grantor should be no worse off (this assumes, of course, that the GRAT was structured so that there was no or minimal gift tax cost at funding).

To make a successful GRAT, the recipe is simple: Select the right investments that have the potential of appreciating or growing during the GRAT term. Without having a crystal ball, there are other ways to structure a GRAT that can increase chances of success:

• **Separate the winners from the losers.**

While it is true that a GRAT can be funded with a multitude of assets, there can be advantages to setting up separate GRATs to hold separate assets or classes of assets. Creating independent GRATs can minimize the degree to which poor-performing investments will taint the higher-performing investments. If all eggs are in one basket, there may be nothing left in the basket after the grantor takes back the required annuity payments — resulting in a failed GRAT. By separating the winners from the losers, overall, there should be a higher aggregate remainder interest available for the grantor's heirs.

• **Backloading annuity payments.**

Although the annuity paid to the grantor is usually fixed, a GRAT may be structured to backload the annuity payments so that they increase each year (the IRS has limited the amount of the increase to no more than 20 percent each year). By drafting a GRAT with increasing annuity payments, the assets in the GRAT are given more time to grow. This minimization of the amount of the annuity at the beginning of the GRAT may ultimately lead to a more successful GRAT as the assets have a chance to appreciate over time.

• **Choosing the right term.**

Selecting the right term for a GRAT can increase a GRAT's chances of performance. The question is whether to make it short-term or long-term. The answer depends on the facts of each particular case, and there are pros and cons to each. In either case, however, it is important to consider the grantor's life expectancy since a grantor must outlive the term of the GRAT in order for the assets to be excluded from his or her estate for estate tax purposes.

There are many reasons to utilize a short-term GRAT (i.e., usually two to four years). By limiting the term of years, there is reduced mortality risk, which is key since the grantor must outlive the GRAT term for it to be successful. Also, a shorter term will reduce a GRAT's exposure to years of poor performance, which could reduce the overall performance. A short-term GRAT also avoids tying up the assets for too long and gets the funds to the remainder beneficiaries sooner. Because of the beneficial features of short-term GRATs, Obama's fiscal 2014 revenue proposals seek to limit the terms of GRATs by requiring a minimum 10-year term — yet another reason that it is a good time to create GRATs while this taxpayer-friendly design option remains available.

While short-term GRATs are popular for the reasons stated above, long-term GRATs may also be appealing. By creating a long-term GRAT, a grantor can lock in the low Section 7520 rate over a longer period of time, taking advantage of today's low rates. Another advantage of a long-term GRAT is that it provides a better platform for backloading annuity payments, an aspect that provides more benefit over a

longer term of years. Long-term GRATs also may be easier to administer rather than having to set up a new short-term GRAT every few years as each prior GRAT's term expires (known as rolling GRATs).

In many instances, it is advisable to create several GRATs with different trust terms in order to hedge the grantor's bets.

• **Power of substitution.**

It may be beneficial to include in the GRAT instrument, and to later utilize, a power allowing the grantor to substitute GRAT assets for other assets of equivalent value. By including this power, the grantor can monitor the performance of the assets in the GRAT and determine whether to swap out any assets during the term of the GRAT. For example, if the assets in a GRAT have appreciated, but the grantor believes that those same assets are likely to decline in value during the balance of the GRAT term (or if the grantor simply wants to lock in the success of the GRAT), the grantor can swap those assets out, while they remain at the higher values, for other assets with greater potential for growth or assets that are more stable or static, such as cash. Substituting the assets is an alternative to selling the assets, which may not be an attractive option since any sale would trigger a capital gains tax.

* * * * *

This is an opportune time to plan with GRATs. The estate planning opportunities that GRATs afford may not be as attractive in the future as interest rates start to increase and to the extent that the current administration's fiscal 2014 revenue proposals are passed to tighten many of the GRAT rules that have favored taxpayers. For those reasons, many taxpayers may want to lock in the estate planning benefits of a GRAT by acting sooner rather than later. •

__Rebecca Rosenberger Smolen__ and __Amy Neifeld Shkedy__ are co-founders of the boutique firm Bala Law Group (__www.balalaw.com__) and concentrate their practices in trust and estate planning and administration.