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GRATs: Make Sure To Sweat All The Small Stuff

Offer opportunities for shifting asset appreciation free of gift and estate taxes

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GRATs are hot. Given today's low interest rates and volatile markets, they afford tremendous opportunities for shifting asset appreciation free of gift and estate taxes. GRATs are seemingly noncontroversial. The GRAT technique is blessed by statute, regulations and case law. The basic GRAT format is simple: (i) a grantor contributes an asset with meaningful appreciation potential; (ii) the grantor receives a fixed payment (typically a percentage of the asset's initial fair market value, computed so that there is virtually no present gift) over a set term; and (iii) the designated remainder beneficiaries receive any value remaining at the end of the term — gift tax free. However, the GRAT format is tightly regulated, so proper care in drafting, funding, and ongoing administration is essential to the success of any GRAT. This article covers several of the most important considerations in designing and implementing GRATs.

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Single Contribution

There can be no "additional contributions" to a GRAT. This requirement poses no problem if a GRAT is created and funded on the same day with a single asset. However, it may not always be possible to transfer assets quickly or at a specified time, especially where the client wishes to contribute multiple assets to a single GRAT. If the IRS determines that the grantor has made one or more additional contributions, the trust will be disqualified as a GRAT and the grantor will be deemed to have made a current gift of the trust assets (disregarding the grantor's retained interest) to the remainder beneficiaries.

To avoid this problem, the grantor can create the trust as a revocable trust and transfer the desired assets to that trust. After all of the transfers have occurred, the grantor can execute a document that waives the revocation power and converts the trust into a GRAT. For tax purposes, a single transfer is deemed to occur at that time, so that there are no additional contributions.

Annuity Payments

A GRAT must make all of the required annuity payments, to the extent it has sufficient assets to do so. That requirement raises both a valuation issue and a timing issue.

A GRAT may satisfy its annuity obligation by distributing cash or other assets (although not by distributing a promissory note). If the GRAT makes a distribution of illiquid assets (e.g., stock of a closely held business, a partnership interest, a fractional interest in real property), it is essential to ascertain the distribution date value of the distributed assets. If the valuation is deemed incorrect (particularly if the distributed asset is overvalued), the GRAT may be disqualified. Even if the valuation is accurate, applicable discounts on the distributed assets can shift appreciation back to the grantor — reversing the GRAT's transfer tax benefits to an extent. In any case, multiple in-kind distributions will require multiple valuations, so it is best to plan for the necessary appraisals at the start of the GRAT term.

Even distributions of marketable securities can raise valuation issues. For gift tax purposes, a marketable security's fair market value typically equals the mean of the high and low trading prices on the transfer date. Using that approach, there is no way to know the precise value of a distributed security until after the last public trade in that security on the distribution date. Fortunately, there is no prohibition on satisfying the annuity obligation through multiple distributions. Thus, one means of avoiding that problem is to satisfy some, but not all, of the annuity payment with a distribution of marketable securities and satisfy the balance in cash once the value of the distributed securities is ascertained.

A GRAT may allow a "window" within which to satisfy each year's annuity payment. The window typically opens on the anniversary of the GRAT's creation and remains open for 105 days. If the GRAT fails to distribute the required annuity amount (or, if less, all of its remaining assets) to the grantor within the window period, that failure may be deemed an additional contribution by the grantor and the GRAT may be disqualified. Within the window period, the trustee has the opportunity to time the distribution to preserve maximum benefit for the GRAT. To the extent the trustee can anticipate fluctuations in the GRAT's asset value during the window period, it is best to make in-kind distributions when the asset value is relatively high, so that greater value is preserved for ultimate distribution to the remainder beneficiaries.

Grantor Trust Status

During the annuity term, a GRAT is a grantor trust, so that the grantor is taxed on the GRAT's income. If the GRAT's remainder interest will pass in further trust, it is essential to consider whether the remainder trust should also be a grantor trust. On one hand, having the grantor continue to pay the trust's income taxes reduces the grantor's taxable estate without gift tax consequences. Grantor trust status also allows for purchases and sales between the grantor and the trust without triggering taxable gains. However, the grantor may not wish to bear continued income tax liability, particularly since the trust may have substantial taxable income and the grantor will not have any economic interest in the remainder trust.

GST Issues

Generally, GRATs are not effective vehicles for generation-skipping planning. For gift tax purposes, a GRAT can shift asset appreciation from the inception date (net of the assumed interest rate used to compute present value) from the grantor's generation to the next. However, for generation-skipping transfer ("GST") tax purposes, that appreciation shift is suspended during the GRAT term; the grantor may allocate GST exemption to the GRAT's assets only after the GRAT term expires, based on the value of those assets at that time. For example, assume a grantor contributes assets worth $2,000,000 to a GRAT and retains an annuity payment stream with a present value of $1,999,999.

Assume further that the GRAT assets appreciate so that after the last annuity payment, the GRAT has $1,000,000 of remaining assets. From a gift tax perspective, the GRAT has been hugely successful: the grantor has transferred $1,000,000 of assets by making a one dollar gift. From a GST tax perspective, the planning has not yet begun: if the GRAT remainder trust is designed to benefit the grantor's grandchildren (or more remote descendants), the grantor would need to allocate $1,000,000 of her GST exemption at the end of the GRAT term to shelter the remainder trust from GST tax.

If the GRAT remainder will pass in trust for one or more members of the grantor's family — even nonskip persons — it is important to determine whether the trust will be deemed a GST trust under the GST exemption allocation rules. For example, assume that the GRAT remainder will pass to a trust for the benefit of the grantor's child (age 30) and that the trust balance will be distributed outright to the child when he reaches age 35. In the unlikely event the child dies before reaching age 35, the trust will be divided into separate trusts for the child's surviving children (the grantor's grandchildren). Despite the unlikely possibility of an actual generation-skipping transfer, that remainder trust is deemed a GST Trust and the grantor's GST exemption will be automatically allocated to that trust at the end of the GRAT term unless the grantor affirmatively elects otherwise on a timely gift tax return.

Given the potential inadvertent waste of a grantor's GST exemption, it is essential to evaluate and discuss GST issues during the GRAT design phase. If the grantor decides at inception that she does not want to allocate GST exemption to the GRAT, she should elect out of the automatic allocation rule on a timely filed gift tax return for the year in which the GRAT is created. Alternatively, if there will be a meaningful possibility of a generation skip in the remainder trust, the grantor may decide to wait and see how the GRAT performs and deal with the GST allocation issue upon the GRAT's termination. In that case, it is essential to remember to address that issue when the remainder trust is funded.

Full Gift Tax Disclosure

Finally, even though the creation of a GRAT typically involves only a de minimis taxable gift, it is important that the grantor timely file a gift tax return reporting that gift. To ensure full disclosure, the return preparer should attach a copy of the trust agreement creating the GRAT, a detailed description of the assets contributed, the basis on which the value of those assets was determined (including appraisals prepared by qualified valuation professionals, in the case of assets other than cash or marketable securities), and a statement describing the mathematical methodology used in determining the value of the gift. Once the grantor provides full disclosure to the IRS, the statute of limitations for gift tax assessment begins to run, thereby reducing the risk of controversy. ■