

MERCER CAPITAL'S

# Value Matters™

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## Grantor Retained Annuity Trusts: A Perfect Storm

The current economic crisis will almost certainly have vast and lasting effects on our country's businesses and financial markets alike. Personal retirement and investment accounts have been battered. The world of gift and estate taxation is full of uncertainty due to the scheduled repeal of estate and generation-skipping taxes set for 2010, while the inauguration of a new president in January 2009 only adds to the ambiguity about changes in legislation going forward. Amid all the turmoil, or perhaps because of all the turmoil, we have encountered a "perfect storm" in which all the conditions are right for the success of a specific gift and estate tax planning tool, the grantor retained annuity trust ("GRAT").

According to the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001, the life-time exemption for estate taxes during 2008 is \$2 million, with a tax rate of 45% on any assets above this limit. As of now, this exemption is set to rise to \$3.5 million during 2009, the taxes will be repealed entirely during 2010, and the exemption will come back during 2011 with a \$1 million exemption and a 55% tax rate<sup>1</sup>. The vast majority of estate planners agree that the legislation regarding these exemptions will change before 2010, but it remains to be determined exactly when and how. Those individuals or married couples who know that the value of their assets at death will far exceed current or projected exemption levels often attempt to pass on some of this wealth to beneficiaries prior to death. Typically, such wealth is subject to gift taxes (at the same estate tax rates mentioned above). However, estate tax planning tools such as the GRAT, when employed effectively, can result in the tax-free passage of some portion of wealth to beneficiaries.

### WHAT IS A GRAT?

A GRAT is a irrevocable trust set up by a grantor, or settlor, to pass wealth to beneficiaries, preferably while paying as little gift tax as possible. The grantor transfers assets into the trust, which is established for a set term, and an annuity is paid back to the grantor during each year of the term. There are no restrictions on the type of assets that may be added to the trust: cash, securities, and interests in partnerships or closely-held business, as well as more illiquid assets like real estate, may all be included in a GRAT.

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<sup>1</sup> "Publication 950 – Introductory Material" <http://www.irs.gov/publications/p950/ar01.html> Accessed November 5, 2008.

For taxation purposes, the IRS assumes an expected level of appreciation, called the Section 7520 rate, for any assets placed in a GRAT. This rate is determined monthly and tends to move in tandem with federal interest rates. The amount of the taxable gift is the fair market value of the property originally transferred to the trust less the present value of the grantor's retained annuity interest, using the Section 7520 rate. Therefore, if the annuity is set such that the two amounts are equal, there is no taxable gift. This is known as a "zeroed-out" GRAT, and any assets remaining in the trust at expiration, effectively any appreciation of those assets above the IRS hurdle rate, will pass to the beneficiaries free of gift taxes.

In order for the strategy to be successful, the appreciation of the assets must surpass the Section 7520 rate, and the grantor must survive the term of the trust. However, even if one of those conditions fails to be met, the grantor is in no worse position economically than had he not established the GRAT, with the exception of administrative fees. If the assets do not appreciate above the IRS hurdle rate, the grantor still recoups his wealth through the annuity payments, and if the grantor dies before expiration, all assets remaining in the GRAT simply become a part of his estate. Therefore, the GRAT has become a popular estate planning tool in the past two decades. The current economic and political environment only increases their present appeal.

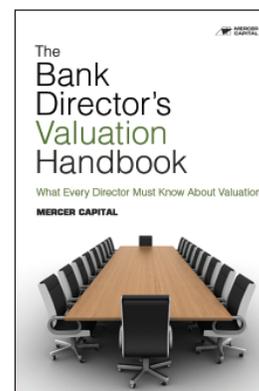
#### THE "PERFECT STORM"

There are several factors contributing to the ideal climate for GRATs. Based on the description above, it is clear that the lower the IRS hurdle rate, the better chance the assets in a GRAT have of exceeding that hurdle rate. The Section 7520 rate for November 2008 is 3.6%. Prior to 2008, the rate had not been that low since August 2003<sup>2</sup>. Because the hurdle rate for the assets for the entire term of the trust, be that two years, ten years, or more, is based on the Section 7520 rate in the month that the GRAT is established, grantors would be wise to lock in low hurdle rates and increase their chances of passing more tax-free wealth to their beneficiaries.

Another consideration is the stock market plummet since October, 2007. GRATs can be formed with marketable securities directly or with interests in limited partnerships that hold marketable securities. With the S&P 500 down over 35% from year-end 2007 at the time this article was written in November, it would seem that most securities' prices have no where to go but up, especially if you consider the several year holding period that a GRAT term would enforce. Even for GRATs formed with interests in closely-held corporations or partnerships containing real estate, the recent general economic decline can lead to initial valuations that are significantly below those seen a year ago. Because the actual appreciation of the assets in the trust, and subsequently the amount of wealth passed on to beneficiaries, has tremendous potential to increase when the GRAT assets begin with a low fair market value relative to recent history, now is an ideal time to create a GRAT for high net worth clients and take advantage of depressed prices.

The third reason to consider a GRAT as an estate tax planning strategy in the near term involves the uncertain future of political decisions, and more specifically, estate planning legislation. As mentioned previously, gift and estate taxes are set to be repealed in 2010,

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<sup>2</sup> "Section 7520 Interest Rates." <http://www.irs.gov/businesses/small/article/0,,id=112482,00.html> Accessed November 4, 2008.

but most believe Congress will intervene during 2009 to reinstate the taxes, as well as a life-time exemption. The questions remaining involve the levels of the exemption and the accompanying tax rate. The uncertainty that already surrounded estate tax legislation is compounded due to the recent presidential elections.

The United States budget deficit is very high, and government bailouts and stimulus packages mean it will only get higher in coming months. Clearly, the government will require significant tax revenue, both in the form of income taxes and gift and estate taxes. According to an article in *Southeast Wealth Management Business* by Jonathan Blattmachr, the most likely scenario once Obama becomes President is a permanent \$3.5 million estate tax exemption with a 45% tax rate. One proposed method to compensate for the increased exemption level is the elimination of the GRAT<sup>3</sup>. With the possibility that the Obama administration may do away with new GRATs entirely, now is the ideal time to consider this strategy.

GRATs are frequently formed using shares or interests in closely-held corporations or family limited partnerships, and it is necessary to obtain an appraisal of these shares or interests to set the initial fair market value transferred to the GRAT. As one of the country's premier business valuation firms, Mercer Capital has experience valuing many such corporations and partnerships. Feel free to give us a call today at (901) 685-2120 if we can help you or your client.



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3 Blattmachr, Jonathan G. "How Would McCain's Election or Obama's Election Affect Estate Tax?" *Southeast Wealth Management Business*. October 2008. Volume 2, Issue 1.

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