

Legislation Update: Grantor Retained Annuity Trusts

In 2008, we described the “perfect storm” of conditions existing at the time that increased the likelihood of success for a grantor retained annuity trust (“GRAT”). Although much has changed since 2008, most of the circumstances promoting the consideration of a GRAT still prevail. The “perfect storm” will likely be stilled if the Senate passes a pending bill. The legislation, called the *Small Business and Infrastructure Jobs Tax Act of 2010* (HR 4849), was passed by the House of Representatives on March 24, 2010.

Lawmakers designed the bill to provide incentives for small business and infrastructure job creation, but such incentives require “Revenue Provisions” necessary to offset spending and tax cuts. Section 307 of the bill acts as one of those revenue generators by expanding the rules on GRATs, which in turn increases the transfer tax income to the federal government. The Congress Joint Committee on Taxation estimates that \$4.45 billion in revenue will be generated over ten years by this provision.

HOW DOES A GRAT TRANSFER WEALTH?

Under certain conditions, a GRAT can result in the transfer of wealth to family members without gift tax. First, a quick overview of how GRATs work. The grantor transfers assets into an irrevocable trust, which is established for a set term, and an annuity is paid back to the grantor during each year of that term. For gift tax assessment, the IRS assumes an expected level of asset appreciation, called the Section 7520 rate. The amount of the taxable gift is the fair market value of the property when it is transferred to the trust less the present value of the grantor’s annuity interest, using the Section 7520 rate as the discount rate. This difference is often referred to as the remainder interest.

The figure below shows a five-year GRAT with the annuity set up such that the remainder interest equals zero, assuming \$10 million of assets are placed into the trust with a Section 7520 rate of 3.4%.



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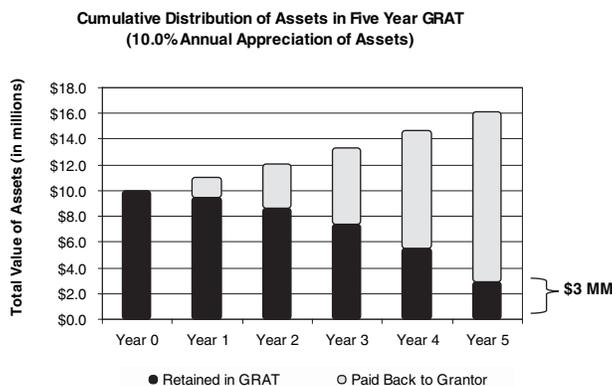
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	Year 1	Year 2	Year 3	Year 4	Year 5
Annuity Payments (in millions)	\$1.5	\$1.8	\$2.2	\$2.6	\$3.1
Value of Assets Transferred to Trust	10				
- Present Value of Annuity @ 3.4%	← (10) ← 3.40% = Section 7520 Rate				
Remainder Interest	\$0				

In order for the strategy to be successful, a portion of the assets transferred must remain in the trust after the satisfaction of the annuity. For this to occur, the return on the assets must exceed the section 7520 rate and the grantor must survive the term of the trust. If the return on assets does not exceed the 7520 rate, the assets will return to the grantor. If the grantor dies prior to expiration of the term, all assets remaining in the GRAT become a part of his or her estate. Therefore, current law limits downside risk of GRATs to wasted legal and administrative fees.

The figure below displays the potential cumulative transfer of assets through the five year GRAT from Figure One, assuming the \$10 million of assets grow at an annual rate of 10.0% after the formation of the GRAT.



At year five, approximately \$3 million dollars of appreciated assets remain in the trust. If the grantor survives the five year term, that portion of wealth passes to the beneficiary free of transfer tax. In this example, 18.1% of the assets placed into the GRAT are transferred to the beneficiary free of tax.

The portion of assets shifted to the beneficiary depends on the spread between the actual return on the asset contributed to the trust and the 7520 rate. If these rates are equal, no assets are transferred through the GRAT to the beneficiary. If we assume that the assets will grow at 15.0% in the previous example, 28.8% of wealth is transferred through the trust. In short, this strategy can benefit those planning to gift appreciating assets.



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NEW LEGISLATION

As mentioned earlier, the current law may have a short life. Section 307 of the pending legislation imposes two major additional requirements on GRATs: (1) the term must be no less than ten years and (2) the remainder interest must have a value greater than zero at the time of the transfer. Thus, as the new bill is currently written, the “mortality risk” of the grantor increases and the taxable gift must be greater than zero. The Senate Committee on Finance may suggest a minimum remainder interest such that a minimum taxable gift amount must be transferred, increasing the downside risk of the strategy. If such an amendment is added and the assets in a GRAT fail to appreciate at a rate greater than the 7520 rate, then the grantor will have paid unnecessary taxes in addition to administrative fees. If the bill remains unchanged from its current form, the positive taxable gift requirement is open to interpretation: could the gift value be \$0.01?

THE “PERFECT STORM” CONTINUES

In 2008, we discussed three conditions that provided a “perfect storm” for GRATs: (1) a low section 7520 rate, (2) depressed asset values in most markets, and (3) the uncertainty of GRAT restricting legislation.

1. A low IRS 7520 rate increases the probability that the return on contributed assets will exceed the 7520 rate over the term of the GRAT, resulting in a transfer of wealth to the beneficiary without a transfer tax. A low 7520 rate also increases the expected portion of assets that could be passed to a family member by means of a GRAT. The 7520 rate is currently 3.4%. Although the rate was as low as 2.0% during part of 2009, the rate was recently as high as 6.2% in August 2007. Many wealthy individuals are setting up GRATs to lock in this lower rate.
2. The S&P 500 has rebounded from 2009 lows, but the value of other assets (privately held companies and other real estate) may not have yet climbed back to pre-recession levels. Realizing a return in excess of the 7520 rate is more likely when starting from a lower base value. Thus, the expected portion of assets passed to a family member increases with relatively lower initial values.
3. GRAT restricting legislation is much more certain today than in 2008. As mentioned earlier, the potential effects of the pending legislation may increase the “mortality risk” and other downside risk of a GRAT. The Senate Committee on Finance may require a minimum amount of a taxable gift when establishing a GRAT. If not, interpretation of the “greater than zero” requirement may be supplied by the IRS.

“If the GRAT strategy meets a potential grantor’s objectives, now may be the time to take swift action”

TIME TO TAKE ACTION

If the GRAT strategy meets a potential grantor's objectives, now may be the time to take swift action.

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. If the pending legislation is seen as the beginning of an era of increased scrutiny, grantors and beneficiaries will benefit from hiring experienced valuation firms they can trust to appraise the assets placed into their GRATs. As one of the country's premier business valuation firms, Mercer Capital has vast experience valuing corporations and partnerships. In addition, we can also value GRATs and provide other GRAT valuation consulting. Feel free to give us a call today at 901.685.2120 if we can



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Mercer Capital's Role in Inman Construction Acquisition

When the shareholders of Memphis-based construction company Inman Construction Corp. began investigating their liquidity options, president Page Inman didn't take long to call on the services of Mercer Capital.

"I know (Mercer Capital CEO) Chris Mercer from church. When I found out what they did and how well-respected they were, I knew they'd be beneficial," said Inman.

Mercer Capital played a pivotal role as transaction advisor to Inman Construction Corp. in its acquisition by Chattanooga-based EMJ Corp., which was made official on March 1, 2010.

"Mercer Capital did a fantastic job walking us through and protecting our interests. I think that's important, to not do it alone and get a well-respected firm to help you throughout the process," said Inman. "Mercer Capital can do everything from valuing a firm to acquisitions and mergers. They served as our advocate. **With something that is as big as selling your company, I think there are too many pitfalls for any one person to know them all. Getting professional help pays dividends."**

"Inman Construction is a forward-thinking company," said Mercer Capital's Nick Heinz, who worked closely with management throughout the two-year process. **"Many business owners don't think about their exit strategies until it's too late. By understanding what options were out there in the market for the company, Inman was well-positioned to explore this opportunity."**

Mercer Capital provides business valuation and investment banking services to clients worldwide. Contact Nick Heinz at 901.322.9740 or heinzn@mercercapital.com to discuss a transaction issue in confidence.

Business Valuation & Transaction Advisory Services

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In addition, Mercer Capital has been successfully executing mergers & acquisitions for a broad spectrum of middle-market companies since the mid-1980s. We specialize in providing merger & acquisition services to sellers or buyers of private businesses or public companies divesting divisions and subsidiaries. In addition, Mercer Capital assists clients in industry consolidations, roll ups, and refinancings.

We provide the following services:

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What's New on Mercer Capital's Web Site

Mercer Capital's web site is updated frequently and contains information of interest to attorneys, business owners, bankers, and other professional advisors to business. Please visit often at www.mercercapital.com.

ANNOUNCEMENT

Mercer Capital Has a New Address

If you haven't already heard, the Memphis headquarters of Mercer Capital has a new address. You can now find us on the 26th floor of Clark Tower, one of the most recognizable buildings in Memphis. Our new address is Clark Tower, 5100 Poplar Avenue, Suite 2600, Memphis, TN 38137. Company phone and fax numbers remain unchanged.

NEW PUBLICATION

Newest Financial Reporting Valuation Flash Published

"Why Quality Matters in Valuation for Equity Compensation Grants" is the lead article in the latest *Financial Reporting Valuation Flash*. Per the article, "For privately held companies (particularly those sponsored by private equity and venture capital funds), getting the valuation process right the first time for equity compensation grant compliance is always the least expensive route in terms of both direct and indirect cost." Also featured in the newsletter is the slide presentation: *ASC 718: Equity Compensation*. Download the newsletter [here](#).



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NEW ARTICLE

Five Litigation Support Services We Provide That Might Surprise You

In litigation involving business valuation or economic damages issues, business valuation professionals are capable of providing a surprisingly broad assortment of litigation support services. These services can begin before a decision is made to file a litigation, and can continue throughout the discovery, deposition, trial preparation and trial processes. Attorneys are increasingly learning that the effectiveness of business valuation and damages-related litigation support services is enhanced by retaining experts as early in the process as possible. To read the article, click [here](#).

SELECTED LIST OF RECENT & UPCOMING SPEAKING ENGAGEMENTS

June 2, 2010

"Valuation Discounts"

The Tax Forum
Memphis, Tennessee
Nicholas J. Heinz, ASA

June 2, 2010

"Professional Services Networking – Your LinkedIn Primer"

2010 NACVA/IBA Annual Conference
Las Vegas, Nevada
Z. Christopher Mercer, CFA, ASA, ABAR

June 3, 2010

"Marketability Discounts & Business Valuation Standards"

2010 NACVA/IBA Annual Conference
Las Vegas, Nevada
Z. Christopher Mercer, CFA, ASA, ABAR

June 17, 2010

"ESOP Repurchase Liability Panel"

New South Chapter of the ESOP Association
Nashville, TN
Nicholas J. Heinz, ASA

August 3, 2010

"Marketing Your Business Valuations & Litigation Services More Effectively"

2010 CPAAI Business Valuation Seminar
Washington, DC
Barbara Walters Price

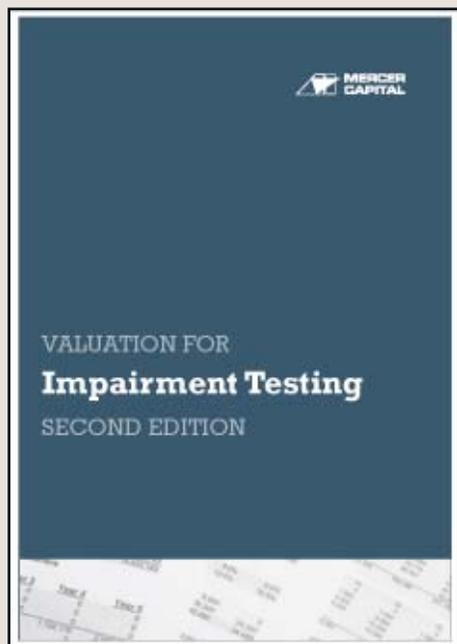
August 27 2010

"How to Know Your Buy-Sell Agreement Will Work Without Triggering It"

BIG Breakfast
West Palm Beach, FL
Z. Christopher Mercer, ASA, CFA, ABAR

To see a complete list, visit the Speaker's Bureau section of our web site at www.mercercapital.com. To inquire about engaging a professional from Mercer Capital to speak to your group, contact Barbara Walters Price at priceb@mercercapital.com, or by calling 901.322.9724.

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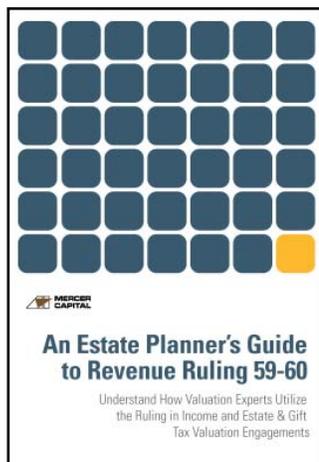
Written primarily for corporate financial managers wary of devoting scarce internal resources to impairment testing, **Valuation for Impairment Testing, Second Edition** is a valuable primer on valuation basics and the unique challenges specific to impairment testing. Providers of impairment testing services, as well as auditors, will also benefit from this book.

The second edition of **Valuation for Impairment Testing** gives readers the inside track, whether discussing valuation approaches and assumptions with auditors or interviewing third-party valuation specialists.

CHAPTER LISTING

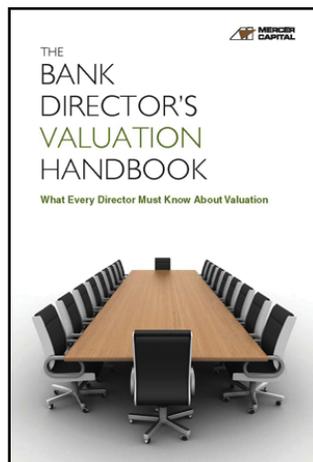
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- Chapter 6 :: DEVELOPING THE CONCLUSION OF VALUE
- Chapter 7 :: MEASUREMENT OF GOODWILL IMPAIRMENT LOSS
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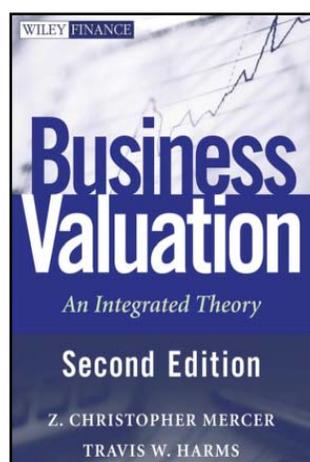
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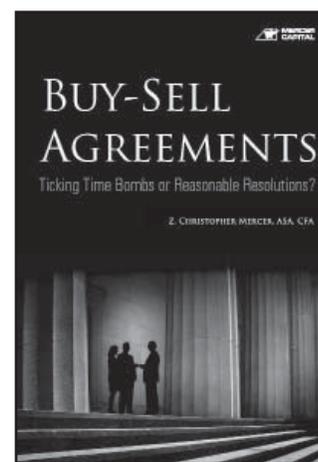
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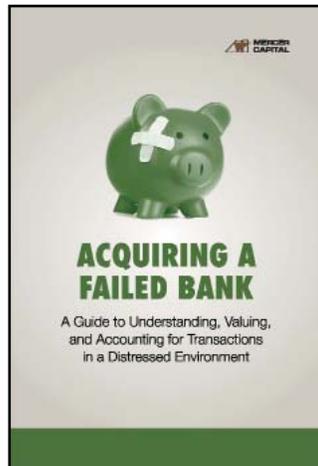
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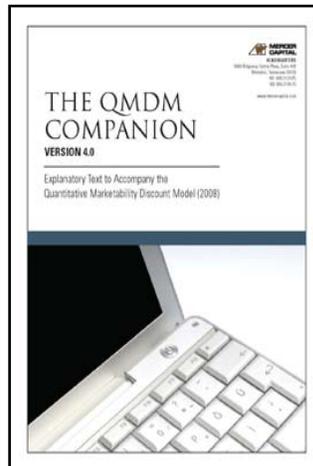
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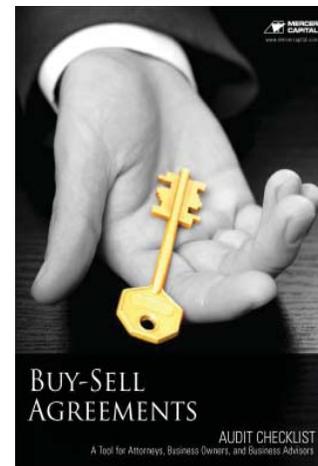
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