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Using GRATs Prior to the Effective Date of the 2704 Proposed Regulations

Variations in this strategy may be preferable in light of the current environment

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On Aug. 4, the Treasury Department issued proposed regulations (the regulations) that restrict or eliminate valuation discounts for family-owned businesses under Internal Revenue Code Section 2704. The regulations will be the subject of a public hearing on Dec. 1, 2016 and will become effective 30 days after publication as final regulations. While many commentators hope that at least some of the harsh provisions in the regulations will be modified before becoming final, can clients afford that risk? For many family business owners, the potential loss of discounts could prove devastating to estate planning (although some commentators have suggested otherwise). For situations in which discounts could be critical, or even important, practitioners should guide clients in evaluating implementing planning prior to the effective date of the regulations. One likely planning technique to be considered for those client situations that might benefit from advance planning is a grantor retained annuity trust (GRAT). But should a GRAT be applied in the traditional manner, or might variations be preferable in light of the GRAT environment?

- A low interest rate environment (that is, a low IRC Section 7520 rate) would increase the probability of success for a GRAT. The current 1.4 percent rate is a very low threshold to exceed and thereby makes GRATs useful from that perspective.
- It's possible there will be a loss of discounts after year end or shortly thereafter when the regulations are anticipated to become effective.
- It's possible that a new administration will pass tax legislation.

GRAT Overview

A GRAT transfers the assets remaining at the end of the trust term to the remainder beneficiaries. This will be the excess of the appreciation of the assets given to the GRAT assets over an annuity payment that includes a return of the principal value of the gift and an interest component determined based on a mandated federal interest rate under Section 7520. The appreciation over this hurdle amount is transferred free of gift tax.

If the GRAT investments outperform the Section 7520 rate, it will transfer the remaining value to the GRAT remainder beneficiaries. For example, a GRAT created in August 2016, without using any gift tax exemption, while the Section 7520 rate is 1.4 percent must return (that is, appreciation and earnings) more than 1.4 percent to leave a balance for the remainder beneficiaries. If the GRAT assets fail to return more than the Section 7520 rate, then the annuity payments to the grantor over the GRAT term will exhaust the trust assets and no remainder passes to the beneficiaries at the end of the term. GRATs have often been structured as short-term (two-year) rolling or cascading GRATs.

GRATs and the Proposed 2704 Regulations

The greater the value of the annuity interest, the smaller the taxable gift involved in the creation of a GRAT. A lower interest rate increases the actuarial value of the retained annuity. Thus, the same annuity payments will produce a lower taxable gift at a lower interest rate. Most important to the regulations is the impact on the value of the assets transferred to the GRAT. The lower the value, the lower the required annuity payment required to reduce the value of the gift to the GRAT to near zero. If a non-controlling interest in a family business is transferred to a GRAT prior to the effective date of the regulations, that value may be discounted, perhaps significantly. If that same GRAT is funded after the effective date of the regulations, that discount may be dramatically reduced or eliminated. This will increase the value of the gift and hence increase the amount of the annuity payment required to reduce the value of that gift to near zero. If the appropriate circumstances are present, it may be possible that the cash flow from the entity can pay the annuity amount and avoid leakage of equity interests into the client/grantor's estate. This may only be achievable if valuation discounts are available. The factors to achieve this might include:

- The value of the discount is sufficient.
- Cash flow from the entity is adequate.
- The grantor's life expectancy is such that the GRAT can be for a sufficient term that the results are obtainable.

Thus, depending on the facts, completing a GRAT prior to the effective date of the regulations might not only be valuable to leverage more wealth out of the estate, but also, it might be essential to the viability of the plan.

Example 1

A family business is valued at $15 million and generates an 8 percent dividend distribution. Ten percent is contributed to a GRAT before the effective date of the regulations. The pro-rata enterprise value is $1.5 million, which is discounted to $1 million. The actual dividend on the 10 percent interest is $1.5 million x 8 percent = $120,000. A 10-year GRAT is created. The required annuity payment of $110,000 results in a taxable gift of $1,497.00. On this basis, the cash dividend from the equity interests will suffice to make the annual annuity payment if the transaction is consummated before the regulations become effective.

Example 2

Planning for the same family business is undertaken, but the 10 percent interest is contributed to a GRAT after the effective date of the regulations. The pro-rata enterprise value is $1.5 million, which can't be discounted. The actual dividend on the 10 percent interest is $1.5 million x 8 percent = $120,000. A 10-year GRAT is created. The required annuity payment of $165,000 results in a taxable gift of $2,245.50. On this basis, the cash dividend from the equity interests won't suffice to make the annual annuity after the regulations become effective. Thus, in-kind payments will be required. This will require an appraisal each year. Further, the "leakage" of business equity back into the grantor's estate won't again be able to benefit from discounts on future post-effective date transfers. This suggests several potential benefits of completing the GRAT planning before that date.

Rolling and Cascading GRATs

A common application of the GRAT technique was short-term, typically two-year GRATs, often done in a series (for example, four GRATs each holding a different asset class). If the assets in one or more of the GRATs grew substantially in value, that excess would inure to the beneficiaries, and the remaining GRATs (that is, those that failed) would have used little or no exemption so that the downside is limited. This excess might simply have remained in the GRAT at the end of a two-year GRAT term. In some instances, if significant appreciation occurred during the term (for example, in the first year of a two-year GRAT), the client/grantor might have substituted cash or Treasurys (non-volatile assets) for the interest to immunize (lock in) the appreciation inside the GRAT and outside the estate. This would minimize or eliminate the risk that the highly appreciated asset might decline in value in later years, thereby undoing the wealth transfer that might have occurred. This all becomes more complex to monitor and address if the term of the GRAT is extended in the current planning environment.

Historically, the unsuccessful GRATs (that is, those that didn't realize sufficient appreciation) would be recycled. A number of points should be noted concerning the application of this technique. President Obama has repeatedly recommended legislative change to curtail this short-term “rolling” GRAT technique (for example, a minimum 10-year GRAT term). If Hillary Clinton is elected, she may push those changes as part of a similar tax agenda. So even if initial GRATs can be created, the potential for future use may be limited.

Although short-term rolling GRATs has been a favored strategy, a risk of using that approach is that GRATs may not survive potential changes to the estate and gift tax law by the next administration. Another risk is that if discounts are essential, or perhaps even useful, to the success of the GRAT, the reduction or elimination of discounts as a result of the regulations are cause to re-evaluate the optimal GRAT strategy. Accordingly, one might reconsider using a longer term GRAT to secure the discounts rather than a short-term GRAT that may have more leakage of the underlying discounted asset back into the grantor’s estate. Thus, while rolling GRATs may have been the favored GRAT strategy in the past, this may not be the optimal approach now.

Immunizing GRATs

A successful GRAT with significant upside could be immunized by swapping out the highly appreciated asset and substituting a low-volatility asset, such as cash. This would serve to lock in the appreciation realized outside the taxable estate.

One difficulty with a longer-term GRAT is that early success may be offset by future failure in asset performance. This was discussed above briefly. If a volatile asset is gifted to a GRAT, appreciates significantly, remains in the GRAT and then declines, some or all of the wealth shift can be lost through this volatility. The client might address this risk in part through a swap power (power of substitution under IRC Section 675(4)(C)) to capture and immunize the volatility in a GRAT. The grantor could exercise the power of substitution when the assets inside the GRAT have appreciated significantly such that freezing that level of appreciation to secure the benefit inside the GRAT for the remainder beneficiaries makes sense. In other words, if an asset in the GRAT doubled in value and the grantor swaps that volatile asset out of the GRAT for an equivalent value of cash, the cash inside the GRAT won't lose value and the appreciation will be secured (locked in). By the grantor substituting a less volatile asset, such as cash, and removing the appreciated asset out of the GRAT, the gain that was made can't be lost. This could be done by a purchase from the GRAT that's a grantor trust, or the grantor can exercise a swap power over a GRAT without a negative gift tax consequence.[1] A swap power should also succeed if the trustee has an obligation to confirm that the property substituted is of equivalent value.[2]

Mortality Risk of Longer GRATs

Another negative of a longer-term GRAT is that death within the term of the GRAT will undermine the plan by likely causing a substantial portion, if not all, of the assets of the GRAT to be included in the grantor's gross estate for federal estate tax purposes. The probability of death within the term of a GRAT can be estimated using the 90CM mortality tables, which are based upon the 1990 census. You might address this risk by:

- Using a tier of GRATs to increase the likelihood of the grantor outliving some.
- Insure the risk (for example, if the longest GRAT is 10 years, purchase 10-year term life insurance).
- Quantify the risk by having an actual life expectancy analysis completed for the grantor, and use that knowledge to set the term of the GRAT.

Post-GRAT Planning

Following the end of each successful GRAT term, GRAT assets could flow into separate trusts for children that remain grantor trusts (that is, taxed to the client) for income tax purposes. Those post-GRAT grantor trusts should include so-called "swap" powers so that the client can swap highly appreciated post-GRAT assets back into their estate for heirs to receive a tax-advantaged step-up in tax basis. The benefit of a post-GRAT grantor trust is generally perceived as beneficial.

99-Year GRAT

A variation of the different applications of traditional GRAT planning discussed above the "99-year GRAT," which applies the GRAT technique in a manner that appears to comply with the technical requirements of the Treasury regulations and that seeks to take advantage of the potential for a significant increase in interest rates between the date the GRAT is established (at today's historically low rates) and the date of the client's death. It might be anticipated that the current historically low interest rates may increase by that time. If the interest rates rise sufficiently, the 99-year GRAT approach could significantly reduce the portion of the entity interests the client contributed to such a GRAT that's included in their estate. If the client completes a 99-year GRAT prior to the effective date of the regulations, then discounts may be permitted. If the client dies following the effective date of the regulations, and more than three years after the transfer, it may be possible that the payment back to the client's estate on death may not be subjected to discounts. If this in fact were the case, it would provide additional advantage to a 99-year GRAT.

A key risk of the 99-year GRAT technique is forecasting interest rates. But while there's certainly no assurance that interest rates will be meaningfully higher on the client's death, perhaps that can be assumed to be a sufficient likelihood so that some discounted entity interests could be committed to this technique regardless. One of the risks with this strategy is that the IRS doesn't approve of the technique, and proposals have been made for Congress to legislatively eliminate this approach. So while this is no doubt a proverbial "red flag" approach, there may still be an opportunity to benefit from it.

Using this concept, the client could fund a 99-year GRAT, valuing a non-controlling interest in a family enterprise at a discounted value before the effective date of the regulations. The client would also determine the annuity payment due each year during the 99-year term based on the current 1.4 percent Section 7520 interest rate. On the client's death, the amount of the assets in the GRAT that must be included in the grantor's estate will be based on the dollar value of assets required to generate the annuity. This value will be determined using the then-current Section 7520 rate.

Thus, if the applicable Section 7520 rate has increased significantly from the date of the initial funding of the GRAT to the date of death determination of this calculation, the amount of property required to be included in the estate will decline. In other words, the only portion of the failed GRAT corpus to be included in the client's estate should arguably be the amount of principal necessary to produce the same annuity payment calculated at the then-higher Section 7520 (interest) rate.[3]

If the interpretation some commentators have given to the regulations is correct, the discount will apply going in to the GRAT because it's consummated prior to the effective date of the regulations, but the discount may arguably not apply "coming out" of the GRAT because discounts will then be prohibited if the amount included in the client's estate is paid in kind. Regardless of whether this benefit is available, it would appear that the consummation of a GRAT with discounted private equity prior to the effective date of the regulations could provide significant additional estate tax planning leverage because the annuity payment will be established with consideration to that discount. Thus, consider creating a GRAT (potentially a 99-year GRAT) before discounts are lost.

Example 3

The client contributes $1 million to a 99-year GRAT in July 2016 when the Section 7520 rate is 1.8 percent. An annuity of $21,700 nearly zeros out the value of the GRAT, leaving a current gift value of $582.63. Assume that in year 6, the client dies and the then Section 7520 rate increases to 6 percent. The amount of the GRAT that must be included in the client's estate is $21,700/.06 = $361,667. In other words, at the higher interest rate, only $361,667 of principal of the GRAT is required to be included in the client's estate to generate the $21,700 initial annuity amount. The 99-year GRAT approach could address the risks of the regulations, as well as future prospective changes to GRATs.

Example 4

The client contributes a non-controlling interest in a family business whose gross value (percentage interest multiplied by enterprise value) is $1.5 million. Because the GRAT is funded prior to the effective date of the regulations, this value is discounted by 33 percent to $1 million. The interest is given to a 99-year GRAT when the Section 7520 rate is 1.8 percent. An annuity of $21,700 nearly zeros out the value of the GRAT, leaving a current gift value of $582.63. Assume that in year 6, the client dies and the then Section 7520 rate increases to 6 percent. The amount of the GRAT that must be included in the client's estate is $21,700/.06 = $361,667. In other words, at the higher interest rate only $361,667 of principal of the GRAT is required to be included in the client's estate to generate the $21,700 initial annuity amount.

Example 5

The client contributes a non-controlling interest in a family business whose gross value (percentage interest multiplied by enterprise value) is $1.5 million. Because the GRAT is funded after the effective date of the regulations, this value can't be discounted. The interest is given to a 99-year GRAT when the Section 7520 rate is 1.8 percent. An annuity of $32,550 nearly zeros out the value of the GRAT, leaving a current gift value of $873.94. Assume that in year 6, the client dies and the then Section 7520 rate increases to 6 percent. The amount of the GRAT that must be included in the client's estate is $32,550/.06 = $542,500. In other words, at the higher interest rate, but without discounts $542,500 of principal of the GRAT is required to be included in the client's estate to generate the increased non-discounted $32,550 initial annuity amount.

Structuring the GRAT

Some of the considerations in structuring a 99-year GRAT plan include:

- Because it's assured that the client will die prior to the end of the 99-year term, this type of GRAT must be structured so that the annuity payments must continue in all events for the entirety of the 99-year term. The annuity and remainder interests can't merge or the valuation and estate inclusion position suggested above may fail.

- Because of the need to continue annuity payments, any estate tax due on the client's death will have to be paid out of assets excluding the 99-year GRAT assets.

Endnotes

1. Private Letter Ruling 200846001 (July 31, 2008).
2. Revenue Ruling 2008-22, Treasury Regulations Section 20.2036-1(c).
3. Treas. Reg. Section 20.2036-1(c)(2).

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