

GRATs Look **GREAT** in October and November (CLATs, RPMs and Other Devices, Too)

Introduction. Estate planners love acronyms, and one of our favorite acronyms these days is **GRAT**, which stands for **Grantor Retained Annuity Trust**. Why? Because, everything else being equal, the lower a particular interest rate (called the "Section 7520 rate"), the better a GRAT will perform. The Section 7520 rate for October is 4.2%. By contrast, the October 2001 rate, at 5.6%, was 140 basis points higher. The November 2002 Section 7520 rate will be 3.6%, the lowest rate in history! The low Section 7520 rates for October and November make this a great time for you to think about creating a GRAT.

What is a GRAT? A GRAT is a special kind of trust to which a person, called the **grantor**, transfers property for a fixed term of years. The **grantor retains an annuity interest in the trust** over such term – thus the name **Grantor Retained Annuity Trust**. When the GRAT terminates at the expiration of the fixed term of years, whatever property remains in the GRAT passes to the persons named in the GRAT agreement, typically the grantor's children (or trusts for their benefit). Depending upon the performance of the property in the GRAT, and the Section 7520 rate in effect when the GRAT is created, a GRAT can be an extremely tax-efficient way to transfer property to children.

You can create a GRAT without making a taxable gift. Under a fairly recent court decision, it is possible to structure a GRAT so that the grantor does **not** make a taxable gift upon the GRAT's creation. And no taxable gift means no gift tax to pay. The way to avoid a taxable gift is to structure the GRAT so that the actuarially-determined present value of the retained annuity is equal to the value of the property the grantor transfers to the GRAT. For example, say the grantor wishes to transfer \$10 million to a GRAT as to which her children are the **remaindermen** (the people who receive property when a trust terminates). In that event, we would structure the GRAT so that the present value of the grantor's retained annuity interest is also equal to \$10 million. Because the value of the interest that the grantor retains is equal to the value of the interest she transfers to the trust, the value of her gift is equal to zero. (In other words, if we tell you that we are going to give you \$10 and then keep it, you might get angry at us, but we haven't made a gift.)

How can a GRAT succeed in transferring property if the grantor keeps what she gives away? This is where the Section 7520 rate comes in, and why this is such a great time to create a GRAT. The Internal Revenue Service requires that we use the Section 7520 rate as the discount rate in order to determine the present value of the grantor's retained annuity interest. Thus, simplifying slightly, if the GRAT is structured such that the present value of the grantor's retained annuity interest and the amount she transfers to the GRAT are equal, and if the property the grantor transfers to the GRAT grows at exactly the Section 7520 rate, there will be nothing left in the GRAT when it terminates. However, if the property in the GRAT grows at a rate in **excess** of the Section 7520 rate, there **will be** property left in the GRAT when it terminates, and that property will pass to the grantor's children **completely free of gift tax**. For this reason, the Section 7520 rate is sometimes called the "hurdle rate." The greater the amount by which the performance of the GRAT beats the hurdle rate, the more will be left in the trust for the grantor's children, and the more the GRAT will succeed in transferring property free of gift tax. **And the lower the Section 7520 rate, the easier it is to beat it. That's why this is such a great time to create a GRAT.**

Illustration. For example, consider a grantor who transfers \$10 million to a 5-year GRAT in October 2002. Assume that the property grows each year at 4.2%, which is exactly equal to the Section 7520 rate for October. We structure the GRAT so that the present value of the grantor's retained annuity interest is equal to \$10 million. Thus, using a 4.2% discount rate, the grantor will receive 5 annuity payments from the GRAT, each of which is equal to approximately \$2.26 million. (Actually, we can squeeze even more benefit out of a GRAT by having the annuity payments start out smaller and then increase, but for the sake of simplicity, the illustrations show level payment GRATs.) Because the property of the GRAT has grown at the hurdle rate, **nothing** is left when the trust terminates, and no property passes to children:

5-year GRAT created October 2002, 4.2% annual growth

	Start of Year	Growth	Annuity	End of Year
Year 1	\$10,000,000	\$420,000	\$(2,258,917)	\$8,161,083
Year 2	\$ 8,161,083	\$342,765	\$(2,258,917)	\$6,244,931
Year 3	\$ 6,244,931	\$262,287	\$(2,258,917)	\$4,248,301
Year 4	\$ 4,248,301	\$178,429	\$(2,258,917)	\$2,167,813
Year 5	\$ 2,167,813	\$ 91,048	\$(2,258,917)	\$ -

However, if the property of the GRAT were to grow at 6% each year, when the trust terminates almost **\$650,000** would pass to the grantor's children (or to trusts for their benefit), **with no gift tax cost**:

5-year GRAT created October 2002, 6.0% annual growth

	Start of Year	Growth	Annuity	End of Year
Year 1	\$10,000,000	\$600,000	\$(2,258,917)	\$8,341,083
Year 2	\$ 8,341,083	\$500,465	\$(2,258,917)	\$6,582,631
Year 3	\$ 6,582,631	\$394,958	\$(2,258,917)	\$4,718,672
Year 4	\$ 4,718,672	\$283,120	\$(2,258,917)	\$2,742,875
Year 5	\$ 2,742,875	\$164,572	\$(2,258,917)	\$ 648,530

By contrast, if the GRAT had been created in September 2002, when the Section 7520 rate was equal to 4.6%, there would be only \$500,000 left in the GRAT when it terminates – in other words, children would get \$150,000 less if the exact same GRAT was created in September 2002 instead of October 2002. And if the GRAT had been created a year ago, when the Section 7520 was a relatively low 5.6%, children would receive only \$145,000.

For more information about how GRATs can fit into your estate plan, and other considerations you should take into account when thinking about GRATs, please call one of these members of K&E's **Trusts and Estates Practice Group**:

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Everything else being equal, a GRAT created in November 2002 **will perform even better than one created in October**. Thus, if the GRAT illustrated above was created in November 2002 rather than in October, over \$860,000 would be transferred free of gift tax – approximately \$110,000 more than in the case of the October GRAT.

Benefits increase as investment performance improves. To illustrate how effective a GRAT can be, the following table shows how much property will be transferred **free of gift tax** by a 5-year, \$10 million GRAT created in November, with varying investment returns ranging from 5% to 8%:

5-year GRAT created November 2002, varying growth rates

	5%	6%	7%	8%
Benefit	\$489,908	\$816,782	\$1,252,626	\$ 1,663,050

There's more to life than GRATs. And just so you don't think GRATs are the only acronyms we have up our sleeves, other estate planning devices, such as Charitable Lead Annuity Trusts ("CLATs"), Remainder Purchase Marital Trusts ("RPMs"), and installment sales to grantor trusts (still working on an acronym), also work especially well in this low interest-rate climate.

Act Now! So if you're interested in effective ways to transfer property to descendants, or to descendants **and** charity, and you don't want to pay gift tax, now is the time to act. Don't delay – **rates may never be this low again!**

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