

Lowe, Brockenbrough recognizes that our clients may require assistance in areas that extend beyond portfolio management. We fully appreciate that some clients have unique and complex investment needs that require additional sophisticated strategies related to the accumulation, preservation and effective distribution of assets.

In an effort to help identify and address the tax and estate issues related to investment management, we are republishing an article on Grantor Retained Annuity Trusts contributed by Farhad Aghdami, a Partner in the Tax Group of Williams Mullen. As the current environment is very favorable for this particular estate planning strategy, we felt that some clients may find this timely article to be of interest.

We sincerely thank Farhad for sharing this valuable and informative piece.

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## ***What Is A GRAT?***

A “GRAT” is an acronym for a Grantor Retained Annuity Trust. GRATs provide clients with the opportunity to transfer substantially appreciating assets to their children and other family members with little or no gift tax cost.

GRATs became extremely popular in 2000, after the United States Tax Court held in favor of the taxpayer in a case called *Walton v. U.S.*, involving Audrey Walton, the sister-in-law of Wal-Mart founder, Sam Walton. The *Walton* case caused the IRS to revise their regulations to provide for this powerful planning opportunity. Now, GRATs are a highly sophisticated planning tool that many wealthy families use to transfer assets to their children and reduce taxes.

## ***Why Should I Consider a GRAT?***

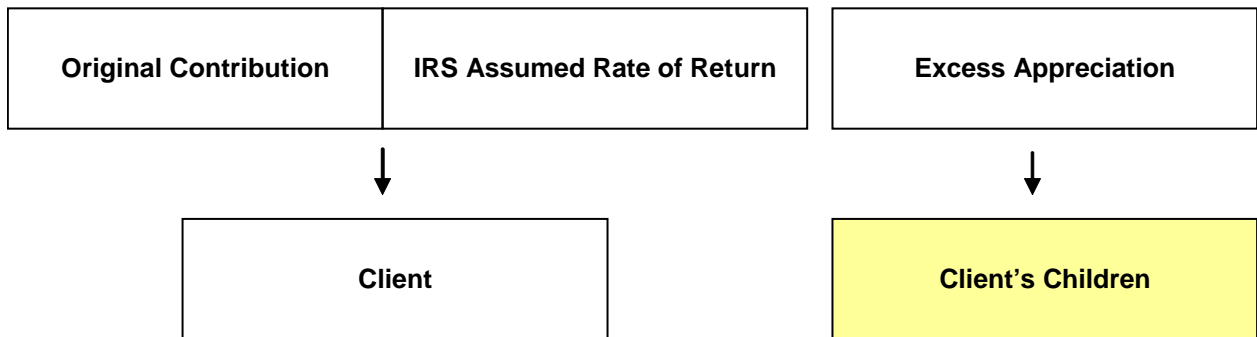
Wealthy individuals facing a sizeable estate tax liability at death can use a GRAT to “freeze” the value of their estate at current values, by shifting most, if not all, of the future appreciation to the next generation. For example, if a client owns an asset worth \$1 million, which is expected to appreciate to \$1.3 million over the next two years, the client can transfer almost all of the \$300,000 of appreciation to the client’s children tax free.

## ***Is Now a Good Time to Consider a GRAT?***

Yes. We believe that current conditions are ripe for GRATs. The interest rates that are used in calculating the tax and financial performance of a GRAT are at an all-time low. The current turbulence in the financial markets is producing outstanding opportunities for clients to transfer assets into GRATs at lower and more favorable valuations. The combination of a low interest rate and depressed valuations produces a superior opportunity to transfer significant wealth at little or no tax cost and with little or no downside risk.

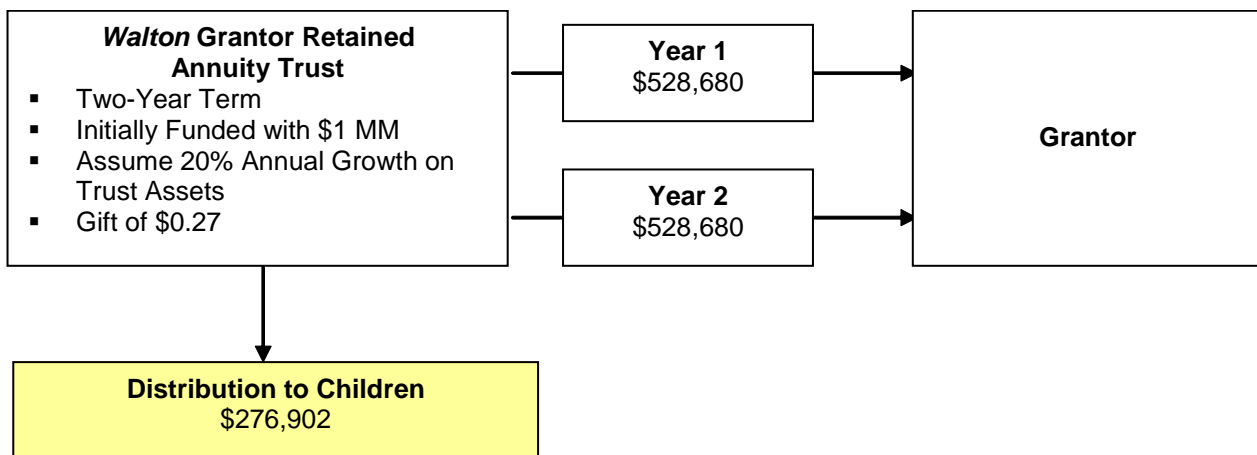
***How Is A GRAT Structured?***

A GRAT is a trust that is established for a specified term of years. The person creating the GRAT (called the Grantor) contributes assets in trust and retains the right to receive, over the term, the original value of the assets contributed to the trust, while earning an IRS assumed rate of return. At the expiration of the trust term, the remaining assets (i.e., the appreciation in excess of the IRS assumed rate of return) are distributed to the Grantor’s beneficiaries, typically the Grantor’s children or a trust for their benefit.



***Can You Provide an Example of a Walton GRAT?***

Assume that a Grantor creates a two-year *Walton* GRAT in June 2008 and funds it with \$1 million. Further assume that the GRAT will achieve a 20% annual rate of return. At the end of Year 1, the Grantor will receive an annuity payment of \$528,680. This payment is calculated as one half of the initial contribution or \$500,000, plus the IRS assumed rate of return (in this case, \$28,680). At the end of Year 2, the Grantor will receive an annuity payment of \$528,680. At that point, the remaining assets, calculated to be \$276,902, will pass to the Grantor’s children (or to a trust for the benefit of the Grantor’s children).



The calculations associated with initial contribution, growth, annuity payments, and ending balance of the 2 year GRAT described above are set forth below:

| <b>Two Year <i>Walton</i> GRAT – Level Annuity Payments<br/>Funded with \$1 Million - 20% Annual Assumed Rate of Return – June 2008</b> |                              |                                  |  |  |
|---|------------------------------|----------------------------------|--|--|
|   | <b>Beginning<br/>Balance</b> | <i>Plus</i><br><b>20% Growth</b> | <i>Minus</i><br><b>Annuity Payment</b> | <i>Equals</i><br><b>Ending Balance</b> |
| <b>Year 1 Results</b>   | \$1,000,000                  | \$200,000                        | \$528,680                              | \$671,320                              |
| <b>Year 2 Results</b>   | \$671,320                    | \$134,262                        | \$528,680                              | \$276,902                              |
| <b>Distributions To Grantor</b>   |                              |                                  | <b>\$1,057,360</b>                     |  |
| <b>Distribution To Children</b>   |                              |                                  |  | <b>\$276,902</b>                       |

In this example, the Grantor transferred \$276,902 to the Grantor’s children for a gift of \$0.27. **Yes – 27 cents.** The gift is determined by subtracting the present value of the retained annuity from the value of the assets contributed to the GRAT, calculated as follows:

|                                   |   |                |
|-----------------------------------|---|----------------|
| Value of Initial Gift             |   | \$1,000,000.00 |
| Present Value of Retained Annuity | - | \$ 999,999.73  |
| Gift to Children                  |   | \$ 0.27        |

If these assets were held until death and taxed at a 45% estate tax rate, the cost to transfer the \$276,802 of appreciation *alone* would generate an estate tax liability of \$124,561.

A 20% annual rate of return is an admittedly aggressive assumption; however, it illustrates the benefit of this planning technique. The chart below sets forth the results with an assumed annual return of 0%, 5%, 10%, 20%, and (just for grins) 50%.

| <b>Two Year <i>Walton</i> GRAT with Level Annuity Payments<br/>Funded with \$1 Million - June 2008</b> |                  |                  |                   |                   |                   |
|--|------------------|------------------|-------------------|-------------------|-------------------|
| <b>Payments</b>  | <b>0% Return</b> | <b>5% Return</b> | <b>10% Return</b> | <b>20% Return</b> | <b>50% Return</b> |
| Year 1 Payment   | \$528,680        | \$528,680        | \$528,680         | \$528,680         | \$528,680         |
| Year 2 Payment   | \$471,319        | \$528,680        | \$528,680         | \$528,680         | \$528,680         |
| <b>Distribution To Children</b>  | <b>\$0</b>       | <b>\$18,704</b>  | <b>\$99,770</b>   | <b>\$276,902</b>  | <b>\$928,298</b>  |

**Why Are GRATS So Popular These Days?**

GRATs perform exceptionally well in low interest rate environments. A significant factor in the actuarial calculations used in determining the annuity payments to the Grantor is the IRS' assumed rate of return (the Section 7520 Rate). The IRS announces the rate each month and it varies from month to month. For example, in June 2008, the Section 7520 Rate is 3.8%; in June 2007, it was 5.6%. In July 2003, it was as low as 3.0% and in May 1989, it was as high as 11.6%.

The Section 7520 Rate represents the “hurdle rate” for the GRAT to be successful. If the assets contributed to the GRAT appreciate at a rate higher than the hurdle rate, wealth will be transferred to the children tax-free. For example, if the assets appreciate at a rate of 10%, when the Section 7520 Rate is 3%, the difference (in this case, 7%) will be transferred to the children tax free.

When the Section 7520 Rate is higher, the annual annuity payment is higher; and, when the Section 7520 Rate is lower, the annuity payment is lower. As a consequence, when the annuity payments are higher, the likelihood of success, i.e., transferring assets to the children, is dampened.

The chart below illustrates the differences in annuity payments when the Section 7520 Rate is at 3.8%, 5.8%, 7.8%, and 9.8%, along with the wealth transferred to the children.

| <b>Two Year <i>Walton</i> GRAT – Level Annuity Payments<br/>Funded with \$1 Million - 20% Annual Assumed Rate of Return</b> |                  |                  |                  |                  |
|---|------------------|------------------|------------------|------------------|
| <b>3.8% to 9.8% Section 7520 Rate</b>   |                  |                  |                  |                  |
| <b>Payments</b>   | <b>3.8%</b>      | <b>5.8%</b>      | <b>7.8%</b>      | <b>9.8%</b>      |
| Year 1 Payment  | \$528,680        | \$543,921        | \$559,221        | \$574,646        |
| Year 2 Payment  | \$528,680        | \$543,921        | \$559,221        | \$574,646        |
| <b>Distribution To Children</b>   | <b>\$276,902</b> | <b>\$243,372</b> | <b>\$209,713</b> | <b>\$175,778</b> |

Based on the assumptions shown above, a GRAT created when the Section 7520 Rate is 3.8% will transfer over \$101,000 more to the Grantor’s children than a GRAT created when the Section 7520 Rate is 9.8% (\$276,902 vs. \$175,778).

**What Happens If The Assets Don’t Appreciate During The GRAT Term?**

This is the beauty of a GRAT. If the assets do not outperform the Section 7520 hurdle rate, the GRAT simply returns the assets, in kind, back the Grantor. The Grantor has paid little or no gift tax on the transfer into the GRAT, so the Grantor simply receives the assets back with no adverse tax consequence. GRATs have been described as a “Heads, I win; Tails, I don’t lose” proposition.

The Grantor can simply re-contribute the assets to a new GRAT with the hope that the assets outperform the hurdle rate in the new GRAT.

***Can The Annual Annuity Payments Vary?***

Yes. The IRS regulations provide that the annual annuity payments can increase by up to 20% per year. Therefore, a GRAT could be structured with increasing annuity payments. This has the effect of back-end loading the annuity payments and leaving more assets inside the GRAT to generate higher returns. The chart below compares a 2 year level annuity GRAT with a 2 year GRAT with annuity payments that increase by 20%.

| <b>Two Year <i>Walton</i> GRAT Funded with \$1 Million<br/>                     20% Annual Assumed Rate of Return<br/>                     June 2008 – 3.8% Section 7520 Rate</b> |                              |                                       |
|---|------------------------------|---------------------------------------|
| <b>Payments</b>   | <b>Level Annuity Payment</b> | <b>20% Increasing Annuity Payment</b> |
| Year 1 Payment  | \$528,680                    | \$481,440                             |
| Year 2 Payment  | \$528,680                    | \$577,728                             |
| <b>Distribution To Children</b>   | <b>\$276,902</b>             | <b>\$284,543</b>                      |

***Must a GRAT have a Two Year Term?***

No. A GRAT can have a term as short as 2 years and as long as the Grantor desires – 20 or 30 years. However, a significant drawback to a GRAT is that if the Grantor dies during the term, all of the assets held in the GRAT at the time of the Grantor’s death, including any appreciation, are included in the Grantor’s estate for estate tax purposes. In order to mitigate the risk of mortality during the term, GRATs are often structured for the shortest term possible – 2 years. This gives the Grantor the maximum opportunity to transfer appreciation on the GRAT assets to the Grantor’s children, while mitigating the risk of mortality during the GRAT term.

Clients who are interested in a long-term GRAT strategy will often create a series of so-called “rolling” GRATs, whereby each annuity payment that is distributed from a GRAT is re-contributed to a new GRAT. Several studies have shown that clients who employ a “rolling” GRAT strategy are able to transfer substantial wealth to their children.

***What Are The Best Types of Assets to Place Into a GRAT?***

Assets that are likely to substantially outperform the Section 7520 Rate are best suited for a GRAT. Very often, entrepreneurs will place pre-IPO stock into a GRAT, with the idea that all of the post-IPO appreciation can be transferred to the entrepreneur's children with little tax cost. Hedge funds, private equity investments, marketable securities, real estate, or other assets that can produce superior returns in the short-term are also well suited for GRATs.

In addition, we often counsel owners of closely-held business interests (partnerships, LLCs, S corporations, etc.) to consider a GRAT, especially when there may be a sale of the business looming on the horizon. The client can transfer an interest in the business to the GRAT and, when and if there is a sale of the business, the appreciation can be transferred to the children tax-free. A GRAT, when properly structured, is a permitted S corporation shareholder and can own shares of an S corporation.

Finally, difficult to value assets are also especially good candidates for GRATs, because a re-valuation (by the IRS) of assets contributed to a properly structured GRAT will not produce an additional gift or gift tax liability to the Grantor.

***What Are The Tax Consequences Of A GRAT?*****Estate and Gift Tax**

From a gift tax perspective, the creation of a GRAT will produce an extremely small gift. As discussed above, assuming a \$1 million initial contribution to a 2-year *Walton* GRAT in June 2008, the amount of the gift will be \$0.27. From an estate tax perspective, the annuity payments will be included in the Grantor's estate. In addition, if the Grantor dies during the two-year term, all of the assets that are held in the GRAT (including any appreciation) are included in the Grantor's estate at their then fair market value; however, the Grantor is no worse off than if he or she did not create the GRAT.

Of course, if the Grantor survives the two-year term, all of the appreciation during the term, in excess of the Section 7520 Rate, is transferred to the Grantor's children tax-free.

**Generation Skipping Transfer Tax**

GRATs are not favored vehicles for transfers to grandchildren or more remote descendants because the generation skipping transfer (GST) tax consequences of a GRAT are not determined until the end of the GRAT term. An exceptionally successful GRAT could produce an unexpected and unwelcome surprise of GST tax when substantial assets are transferred to grandchildren. Because of the uncertainty of the GST tax consequences, many estate planners and their clients are reluctant to create GRATs for the benefit of grandchildren.

**Income Tax**

From an income tax perspective, a properly structured GRAT will be treated as a grantor trust. Therefore, all of the GRAT's income, gain, loss, and credit during the two-year term will be taxed to the Grantor. The IRS has ruled that the Grantor's payment of the income tax liability associated with the GRAT is not treated as an additional gift to the GRAT. This produces an additional benefit to the GRAT's remainder beneficiaries, since the assets are not eroded by any income taxes.

At the expiration of the GRAT's two-year term, the assets pass to the Grantor's children (or to a trust for their benefit) will not receive a step up in basis; rather they will have a carry over basis for tax purposes. Therefore, it may be prudent to select higher basis assets for contribution to the GRAT. In addition, it may be possible, in a properly structured GRAT, to "swap" out low basis assets for high basis assets, if appropriate.

**Conclusion**

We believe that now is an excellent time to consider a GRAT. The combination of low interest rates and depressed valuations produces a superior opportunity to transfer significant wealth at little or no tax cost and with little or no downside risk.

Should you have any questions, please contact Lowe, Brockenbrough & Company, Inc. at 804-288-0404 or 1-800-787-7414.

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