GRATS ARE GR(E)AT FOR TRANSFERRING S CORPORATIONS TO THE KIDS

What is it and Why?

The grantor retained annuity trust ("GRAT") has been statutorily allowed by Congress since 1990. Used properly, the GRAT can transfer part or all of a wealthy person's business to the next generation, free of gift tax and in a way that removes the business from estate taxation.

A GRAT with a business interest is created by a grantor transferring a portion of his interest into an irrevocable trust and retaining the right to an annuity interest ("a qualified interest") for a fixed term of years. *See, e.g.*, 26 U.S.C. 2702(b). When the fixed term of years, call it the "retained interest period", ends, any assets remaining in the trust pass to the named remainder beneficiaries.

The required elements include: (1) a trust, which is (2) irrevocable, and (3) includes provisions required by section 2702 of the Code, and (4) receives assets transferred by the grantor to the trust, and (5) sets forth an amount to be distributed to the grantor periodically, for (6) a determined period of years.

In order to result in no gift tax, the value of the qualified interest must equal the value of what was transferred. Therefore, the S corporation stock must be valued for these purposes. And the planner must do an actuarial calculation that sets the annuity amount * term of years, at the required interest rate, equal to the valuation.

> **Example 1:** Grantor G transfers a 10% interest in his S corporation, valued at $1,000,000, to an irrevocable trust, drafted pursuant to section 2702 of the Code. Under the terms of the trust, G retains the right to $280,000, payable annually, for a period of 4 years. The gift tax value of the transfer is $0, calculated assuming a section 7520 rate of 4.6%.

The Gift Tax Elements

Section 2702 provides rules as to how to value the gift tax element of a GRAT. The gift tax value of the transferred assets is determined at the time the trust is created and funded using the "subtraction method." Under this method, the value of the annuity interest the Grantor retains is subtracted from the fair market value of the assets the Grantor placed into the trust to determine the amount of the Grantor's gift. Code Sec. 2702(a).

The value of the annuity is determined by reference to section 7520 of the Code, and uses 120% of the federal midterm rate in effect for the month of the transfer to determine the discounted present value of the annuity. The discounted present value of the annuity is an algebraic calculation, discussed in detail later in the outline, and can be determined by any one of various computer programs. (This author uses a product known as "Z calc," whose email address is www.zcalc.com).

> **Example 2:** In Example 1, G retains the right to $280,000 for 4 years. Assume the required discount rate to value this $280,000, for the month of transfer, is

4.6%. Initially, then, the step is to determine the value of $280,000 received for four years, assuming the required rate of return on this money would have been 4.6% per year (stated another way, that the investor could have earned 4.6% per year on the $280,000, so each time the $280,000 is received, it is worth $280,000 less the 4.6% return on that money over each year it is deferred). Pursuant to a mathematical equation, the value of this is $1,000,261. Second, the value of the transferred property is $1,000,000, so the gift tax value is $1,000,000 less $1,000,261, or a negative number. Since one cannot have a negative gift, the gift tax value under the rules prescribed by the Code is 0.

The Gift Tax Benefit of a GRAT

All income and appreciation in excess of that required to pay the annuity accumulates for the benefit of the remainder beneficiaries. Consequently, it may be possible to transfer assets to the beneficiaries when the retained interest period terminates with values that far exceed their original values when transferred into the trust and, more importantly, that far exceed the gift tax value of the transferred assets. In zeroed-out GRATs, the gift tax value is zero, so any amount that remains after the retained interest term has effectively been transferred gift tax free.

Example 3: The value of the property that G transfers to the trust in Example 1 increases annually by 10%. At the end of 4 years, $164,620 remains and passes to the remainder beneficiaries of the GRAT free of any gift or estate tax consequences.

The Estate Tax Elements.

The transfer to a GRAT is a transfer with a retained interest, a term that invokes section 2036 of the Code. Section 2036 applies at a person's death to previously transferred property, and all the transferred property is included in the grantor's gross estate.

With regard to a GRAT, if the grantor dies within the retained interest period, that is, during the time the grantor is required under the terms of the GRAT to receive the annuity, the full value of the GRAT is included in the grantor's gross estate, as it exists at the grantor's passing. Inclusion in the grantor's gross estate has been held in all circumstances by the Service, which has resorted to section 2039 of the Code as well as 2036 in reaching that result.

Decisions to be Made at the Time the GRAT is Established

In structuring the GRAT with S Corporation stock, the client and advisor must make two important decisions. First, how long is the retained interest period? The longer the period, the longer the grantor must survive in order for the GRAT to be out of the grantor's gross estate. If the grantor dies during the retained interest period, the property is included in the grantor's gross estate.

Conversely, the shorter the retained period, the larger the annuity needed in order to zero out the GRAT. And this means that the property does not have as long a period of time to get the benefit of the appreciation.

The second variable is the amount of retained annuity, which is typically set at a fixed percentage of the initial fair market value of the property transferred to the GRAT. In S Corporation planning, the retained annuity amount is the first determination, based on expected cash flow, and then the term of years becomes the plug to zero out the GRAT.

> **Example 4:** In the GRAT in which G has transferred his S corporation interest worth $1,000,000, G determines that the Company can generate $98,457 a year in before tax cash flow as to this interest; and he wants to limit his annuity right to this amount. To zero out the GRAT, assuming that $98,457 will be received each year, the GRAT must be for a period of 14 years.

Zeroing Out

Zeroing out GRATs for gift tax purposes should have been achievable since 1990. The valuation of the retained interest is a straightforward discounted present value of an annuity for a term of years. The term of years should pay out in the GRAT regardless of whether the Grantor is living or has died during that time. If the Grantor dies during that time, the remaining annuity interest should be paid to his estate. In this way, the value of the annuity will not be based on any life expectancy issues. Although reluctant to do so, the Service has agreed that GRATs can be zeroed out regardless of life expectancy. Recently, the Treasury has issued new regulations to this effect. 26 CFR Part 25 [TD 9181]RIN 1545-BB72.

Payment of Income Tax

The grantor must pay the income tax on the GRAT during the retained term. This is both required and a positive net cash flow result to the GRAT.

The payments by the GRAT to the grantor are in effect the payment of an after income tax obligation (to the grantor) with before income tax dollars. After the retained term, the grantor trust status can be continued in order for the grantor to continue to pay the income tax related to the GRAT assets.

And because the GRAT is a grantor trust during the retained term (and perhaps thereafter if structured as such), the GRAT qualifies as an S corporation shareholder.

Setting the Term Consistent with Cash Flow

The variables that come into play in using GRATs with S corporations are (1) valuation of a closely held corporation, (2) discounting, and (3) determination of cash flows.

a. Valuation

Under the Code, the valuation methodology for a closely held business is left uncertain. Closely held corporations are typically thought of as family businesses, but in reality, encompass a wider range of businesses and include all those business interests that are not publicly traded. The valuation is typically done by a business appraiser.

Attempts are given in the Code to prescribe variables and boundaries to value these closely-held business interests, but not much certainty is provided. For example, the operative revenue ruling, Rev. Rul. 59-60, 1959-1 C.B. 237, sets forth various factors to be considered in any valuation:

(a) The nature of the business and the history of the enterprise from its inception.

(b) The economic outlook in general and the condition and outlook of the specific industry in particular.

(c) The book value of the stock.

(d) The earning capacity of the company.

(e) The dividend-paying capacity of the company.

(f) Goodwill and other intangible value.

(g) The size of the block of stock to be valued.

(h) Market price of comparable traded companies.

The real value of the closely-held interest is what it would sell for to a third party on the relevant valuation date. Treas. Reg. 26 C.F.R. § 20.2031-1(b) and 26 C.F.R. § 25.2512-3. This is usually measured by what a similar interest in the same company has sold for to a third party on that date. But because the interest is not publicly-traded (a result that emanates from the definition of a closely-held interest), there is generally no comparable interest in the same company that has sold on that date.

Accordingly, in a conceptual sense, the taxpayer has to approximate what the interest **would** sell for to a third party on that date. And the reality is that there is typically a range of values as to what the interest might sell for. The taxpayer and the Internal Revenue Service (the “Service”) have disparate objectives as to which point on the range they would desire.

b. <u>Discounting</u>

Once the entity value is arrived at, the interest being valued could be capable of further discounting. The type of discounts that will be appropriate in a valuation could include any of the following:

<u>A Non-Controlling, or Minority, Interest.</u> This type of interest renders the interest holder the recipient of "what he gets" in the enterprise. For example, distributions annually, determinations as to how to invest the assets, and determinations whether to sell or liquidate the enterprise, are beyond the investor’s control. As a passive investor, his interest becomes worth less than its *pro rata* share of the enterprise as a whole (based on the calculation of share ownership expressed as a percentage * value of noted enterprise). In Peracchio v. Comm'r, T.C. Memo 2003-280, Judge Halpern with regard to a limited partnership in a partnership invested heavily in marketable securities:

> "The parties agree that the hypothetical 'willing buyer" of a transferred interest would account for such lack of control by demanding a reduced sales price; i.e., a price that is less than the interest's *pro rata* share of the partnership's NAV," at 285.

Marketability Issues. An interest that does not have a readily available market in which to sell the interest is worth less. For example, if a seller knows there is only one buyer for her interest, that buyer has substantial leverage to negotiate a lower price. The more buyers there are for an interest the more bidding that could occur for that interest, and the more likely that the interest will sell at a higher value. For example, a publicly-traded security will sell at a higher value than a privately-held security, all other variables being equal, because the market for potential buyers is greater.

Discount for Built-in Liabilities. If a buyer purchases on asset that will have liabilities associated with it, including taxes, the buyer will pay less to take into account liabilities that the buyer will have to incur in the future. The most common types of built in liabilities include current debt, environmental issues, contingent lawsuits, and accrued but unpaid taxes. Other than issues associated with taxes, the other types of liabilities are a straight offset against the arrived at value of the enterprise, on a gross basis. As built in capital gains or other income taxes, there are enough cases now allowing these discounts that they need to be considered in many valuations, but must be specifically demonstrated as to how to affect value, versus just reducing the valuation by the expected capital gains rate. But see Davis v. Commissioner, 110 T.C. 530 (1998) and Eisenberg v. Commissioner, 155 F.3d 50 (1998) 1999-1 C.B. XIX, 1999-4 I.R.B. 4, 1999 WL 33541682 (IRS ACQ).

c. Cash Flow

And then cash flow expectations are picked up by the Company's financial statements. From the Income Statement and Balance Sheet of a Company, the Cash Flow Statement of a company can be determined. Essentially, this Statement sets forth the actual cash that was generated from the business operations, and how much cash was derived or used for financing, for reinvesting (in capital projects), and how much remains available for distribution to shareholders. For an S Corporation that is mature and producing available cash flow for distributions, this statement is very important, especially on a going forward and going backwards basis.

> **Example 6**: An S Corporation is in its 8th year of producing Formica desk tops. It invests very little in the way of new manufacturing processes. The net cash that it has generated the last three years, after financial costs have been subtracted, has been $900,000, $800,000, and $975,000. This becomes extremely

important in GRAT modeling because the planner can assume that a minimum of $800,000 of cash flow could be available to pay the annuity if 100 % of the corporation is transferred to the GRAT, or a pro rata portion of that $800,000 based on the percentage transferred.

Putting these all together allows the planner to structure the GRAT.

GRAT Structuring Example 7: An S Corporation services air conditioning and heating equipment, and has free cash flows of $900,000, $1,000,000, and $800,000 over the last three years. The capital structure is that 90% of the equity is represented by nonvoting interests, which will be transferred to a GRAT, and 10% by voting interests, which will be retained by the grantor. The grantor, aged 70, currently owns all 100% of the Company's equity.

It is expected that cash flows for the next few years will approximate these cash flows. Using as a benchmark the 3 prior years' average cash flow of $900,000, and assuming these cash flows will continue in perpetuity without growth (or diminution), the value of the company as a whole will be $900,000/ X, where X is the discount rate used to approximate the risk of these cash flows. Assume that the business appraiser concludes that the company should be valued using a cost of capital at 15%. At 15%, the value of the Company is $6.0 million. Now the appraiser discounts the value of the 90% nonvoting piece for illiquidity and non-control by 30%, to $4.2 million * .9, or $3.78m.

For how long should the GRAT be structured? Using the March section 7520 rate of 5.4%, a six year GRAT will require the annual payment of approximately $754,000, in order to zero out the gift tax value. It matters not that the cash flows are "pre tax," since the grantor, not the GRAT, pays all income taxes. Hence, if the GRAT is able to receive greater than $754,000 per year of pre tax cash flow from the company (and remember that the GRAT as the 90% owner of the equity of the company, is entitled to 90% of the cash flows), then the GRAT can pay the required annuity.

Looking at the Company's generated cash flow over the prior three years (approximately $900,000 annually), that amount seems sustainable, with room for cushion should cash flows be lower over the six year period, or the IRS assert a greater valuation, thereby requiring the readjustment of the annuity amount. Importantly, at age 70, the grantor's life expectancy is well over 12 years, and a six year GRAT seems a safe bet that the grantor will outlive that term. If all goes as planned, at the end of six years, the annuity will have been satisfied, and 90% of the equity of the company will have been successfully transferred to the beneficiaries outside of the gift and estate tax system.

Conclusion

In the world of estate planning, for those S corporations that generate sufficient cash flow, the GRAT will be the strategy of choice to transfer value down to the next generation without incurring any estate or gift tax costs.