

By Robert T. Napier

GRAT Expectations

Despite pending legislation, the sun isn't yet setting on this useful planning tool

Somewhere in a bleak house in Washington, D.C., a plot exists. The conspirators are working against a favorite planning tool, the grantor retained annuity trust (GRAT). Bill after bill has been born to limit the flexibility and power of the GRAT.¹ The authors of these legislative works have great expectations to oppress this popular idea.

These proposed changes would include requiring a GRAT term of at least 10 years; requiring fixed annuity payments that, when determined on an annual basis, couldn't decrease during the first 10 years of the GRAT's term; and requiring a GRAT remainder interest that would have to be greater than zero. All these bills would be effective for transfers made after the date of enactment. It's noteworthy that the GRAT provisions of the three most recent bills contain identical language.

"Please, Sir, may I have some more?" Regardless of the outcome of these specific bills, it seems clear that the zeroed-out *Walton*² GRAT has a bull's-eye squarely on its forehead.³

So what can financial advisors, certified public accountants and attorneys learn from the drumbeat of assaults on the *Walton* GRAT? Is the sun setting on GRATs as a planning tool? Just as the ghost of Christmas Future incorrectly foretold the passing of poor Tiny Tim, the suggestion that GRATs will die as a planning tool may be greatly exaggerated.

Present Law

As of this writing, the GRAT is still a great idea. Since none of the newly proposed GRAT legislation has been enacted, clients are well-advised to continue to employ

the tool as it has been implemented over the past decade or so. During that time, many clients favored a two-year term. This time frame is popular as it allows clients to build a trust, fund it and see if the assets in the trust appreciate over the brief two-year term. No worries if the assets fail to appreciate beyond the required Internal Revenue Code Section 7520 hurdle rate; the client could simply reload a new GRAT and try again.

Research suggests that the odds of the client enjoying a successful rolling two-year GRAT strategy over a 10-year period is over 90 percent.⁴ The House Ways and Means Committee observed the power of the two-year rolling GRAT strategy and proposed the above-referenced pending legislation with its mandatory 10-year minimum term.

However, in this legislative environment, is the traditional two-year strategy the best one to implement now? A compelling argument can be made that a somewhat longer-term GRAT may be more appropriate; this may be the case since it's quite possible that clients will not be in a position to roll their short-term trusts in two years' time. If that's true, a somewhat longer-term trust may be uniquely advantageous to current planners.⁵

Future Strategies

Even if short-term GRATs become prohibited in the future, the GRAT strategy will still be appropriate for many clients. Only the eldest among us or the most infirm needs to deploy short-term GRATs. Longer-term trusts can still succeed. An ironic and probably unintended consequence is that clients may become comfortable establishing longer-term trusts; termination 10 years in the future may seem so remote that long-term GRATs could conceivably become more popular. Many clients have seen the compelling possibilities of GRATs, yet elected not to use them for fear that they may need the appreciation on the trust assets.



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Longer-term trusts may help allay those concerns since the pending legislation allows the grantor-client to retain the GRAT annuity for at least 10 years. If the pending legislation, or something like it, is ultimately passed, younger clients will need to think of their estates with a long-term view.

Note that the pending legislation prohibits decreasing the annual distribution amounts. While this provision's intent is unknown, it results in the elimination of front-end loading of trusts. This would have been an intriguing strategy for aged or infirm clients. The proposed language ups the ante for clients that pass during the term of the GRAT and lessens the ability of planners to game the GRAT rules.

The Safety GRAT

It's quite difficult to forecast the future financial needs of a family and impossible to forecast future estate tax laws. Some taxpayers have quipped that they will defer serious planning until the estate tax laws are finally settled. Given that the estate and gift tax laws are almost always in some state of flux, those folks are deservedly called "taxpayers." Nonetheless, in light of these substantial variables, a reluctance to make irrevocable decisions today about the future seems entirely understandable. This may explain why 10-year GRATs currently seem as common as black swans or Chicago Cubs playoff victories.

One idea to help alleviate clients' economic uncertainty about the future may be a strategy that I call the "Safety GRAT."⁶ Anecdotal experience suggests that nearly all current GRATs leave the remainder to the younger generation, either outright or in trust. This can be quite troubling to clients making decisions today for a generation that could still be maturing.

Rather than leaving the remainder to the younger generation, many clients are intrigued by leaving the remainder to a trust for the younger or healthier spouse. If the GRAT remainder is left in a trust for the non-grantor spouse, the appreciation on the GRAT can escape estate taxation at the parents' level but the appreciated assets are still available for the non-grantor spouse. This is like a modern-day emergency fund for the affluent. This strategy can be especially appealing in a minimum 10-year GRAT environment.

Multiple Rolling GRATs

The pending legislation rewards those taxpayers astute enough to employ long-term planning techniques. Call it survival of the fittest for the wealthiest among us. While this author has never met a client willing to deploy the following idea, and the idea may be contrary to the spirit of the pending legislation, an opportunity may exist.

Assuming the legislation is passed in its current form, a very wealthy client could fund a series of roll-

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ing 10-year GRATs. In time, those trusts will age and effectively become shorter-term GRATs. If these rolling trusts utilize the 120 percent payout rule, and perhaps exploit the 105-day annuity payment grace period, the client may eventually be in a position similar to the position she would be in under the current law. Assets originally used to fund the GRAT could be swapped in the future for new business ideas or opportunities that arise. Of course, few clients may have the appetite to fund rolling trusts of this nature, but the potential for the most foresighted could be meaningful.⁷ Hedge fund managers, pre-initial public offering shareholders or anyone anticipating exposure to future opportunities or asset appreciation can exist in a long-term GRAT environment.⁸

Compliance

Gift tax filing obligations under the pending legislation would be clearer than it is now. Professionals have often debated whether the remainder interest of a GRAT could be zero or if it was more prudent to calculate the remainder interest as being slightly greater than zero. Accordingly, since the pending legislation requires that

the value be greater than zero, a gift tax return should be filed. This is probably a prudent requirement since the filing of the gift tax return should start the statute of limitations running.

Professional Oversight

Professional advisor involvement becomes ever more critical in the environment contemplated by the pending legislation. Examples of charitable remainder trusts and GRATs that have failed to follow their required formalities are abundant. Disallowance by the IRS of a GRAT that has been neglected by the client or her advisors could be costly. Longer-term GRATs afford significantly more opportunities for failure to follow formalities, like timely distribution of required annuity payments.⁹ It's easy to envision a client changing advisors during the GRAT term and the successor advisors remaining unaware of the GRAT obligations.

Similarly, if a GRAT has been successful, but hasn't yet terminated, neglect of the trust assets could cause gains to erode and the loss of hard earned profits. Astute financial advisors will take affirmative steps to "immunize" or effectively lock in gains of a successful GRAT that isn't close to terminating. Longer-term trusts may also be exposed to multiple economic cycles, thereby jeopardizing the results of the trust.

Collaborative Involvement

Clients also have their own GRAT expectations.¹⁰ They believe that pressing the print button for a new GRAT shouldn't cost thousands of dollars. Clients are often and understandably frugal, which may explain how they amassed their wealth in the first place. Unfortunately, life and GRATs aren't simple. In an environment where GRATs may have a mandatory 10-year minimum sentence, it's important that a client and her advisors collaborate on the trust funding and strategy. Too often, clients have artificial or arbitrary cost constraints that limit the strategizing that is typically critical for successful planning. This type of collaborative involvement among complimentary professionals is of special significance in a 10-year GRAT environment. The carpenter's adage of "measure twice, cut once" is especially appropriate if a client is committing to an irrevocable 10-year plan.

The legislature, advisors and clients all have many GRAT expectations. While the future is never perfectly clear, and while future and present GRAT laws may differ, the expectation is that GRATs will survive as a useful planning tool.

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—*Author's note: The author had intended to publish this work in serial format but was informed by the editors that some guy named Dickens had already done that with a similar title.*

Endnotes

1. See Treasury Department's "General Explanation of the Administration's Fiscal Year 2010 Revenue Proposals" (Greenbook, May 11, 2009.) See also Section 307 of the Jobs Bill (H.R. 4849), Section 531 of the Small Business Infrastructure Jobs Tax Act of 2010 (H.R. 5486) and Section 8 of Senate Bill 3533.
2. *Walton v. Commissioner*, 115 T.C. 589. In *Walton*, after finding that Audrey J. Walton (either individually or through her estate) retained the grantor retained annuity trusts (GRATs) in their entirety, the court found that the two GRATs created "a single, noncontingent annuity interest payable for a specified term of years...." In addition, the court further held that Treasury Regulations Section 25.2702-3(e), Example 5 was "an unreasonable interpretation and an invalid extension of Section 2702."
3. By their own estimates, if these GRAT bills were to become law, only about \$5 billion in additional revenue will be raised over a 10-year period. Joint Committee on Taxation, Estimated Revenue Effects of H.R. 4849, the "Small Business and Infrastructure Jobs Tax Act of 2010," Scheduled For Markup by the Committee on Ways and Means on March 17, 2010, JCX-12-10, March 16, 2010.
4. David L. Weinreb and Gregory D. Singer, "Rolling Short-term GRATs Are (Almost) Always Best," *Trusts & Estates*, August 2008 at p. 18.
5. "A Last Bite at the GRAT Apple?" *In Your Interest an Informative Edge From the Advice Lab of J.P. Morgan*, May 10, 2010.
6. Robert T. Napier, "The Safety GRAT," *Illinois State Bar Association Trusts & Estates*, Vol. 55, No. 8, June 2009 at pp. 1-2.
7. Valuation issues and appraisal costs for assets without a readily available value could be significant.
8. For additional insights, see "Pulling the Rabbit out of the GRAT Hat: the 90% Mortgaged GRAT," Goldman Sachs Strategic Wealth Advisory Team, June 2010.
9. This risk can be addressed with careful drafting.
10. Here are some of the top reasons many clients have certain expectations when it comes to fees for successive GRATs:
 - You crafted a GRAT for this client earlier, so all you have to do is reprint the old one and change a few words.
 - Robert Shapiro is running a special on GRATs this month on *LegalZoom.com*.
 - Your client knows a guy that can prepare GRATs inexpensively. You should match his price.
 - There has to be a sample GRAT on the Internet. In fact, your client is tempted to find you a template for a GRAT and send it to you, just to help get you started.
 - Your client has a daughter in law school. If you can't get it done quickly and cheaply, his law student daughter will do it.
 - Your client can do this himself—send him a GRAT form and he will fill in the blanks.
 - The last GRAT you drafted for this client failed because his investments didn't appreciate. Accordingly, you owe him a GRAT that will work (come on, you are supposed to be good at this).