

## GRATs: Make hay while the sun shines

If Obama has his way, grantor remainder annuity trusts will become less attractive

By Robert N. Gordon

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In his book "Integrated Wealth Management: The New Direction for Portfolio Manager" (Euromoney Institutional Investor, 2006), Jean Brunel educates us as to the benefits of asset "location" — not to be confused with asset allocation. He tells us that placing assets in the proper pocketbooks can allow tax-efficient wealth transfer. For example, we all know not to put tax-free munis in an individual retirement account, but the rules concerning trusts and intrafamily giving offer the potential for a different kind of tax efficiency.

Consider grantor remainder annuity trusts. They are commonly used in the wealth transfer plans of high-net-worth individuals who believe that the money they leave to heirs will create an estate tax burden. As a result, they endeavor to transfer as much money as they can to the next generation without triggering gift/transfer taxes. Most already avail themselves of the annual gift tax allowance of \$13,000 per person per donor; they are concerned about amounts above that.

As it is explained to me, an investor first funds the GRAT with cash or an asset. If its investments produce returns in excess of a stated amount, the appreciation above that hurdle rate is transferred to the next generation without any effect from the gift/transfer tax rules.

Revenue Ruling 2009-33 has set the applicable federal rate under Section 7520 for GRATs established in October at 3.2%, compared with 3.4% in September and August. Logically, it's best to establish GRATs when interest rates are historically low as they are now.

The president's tax proposals, unfortunately, contain a provision designed to make GRATs less attractive. Under the president's plan, the minimum term of GRATs would be extended to 10 years, from the current two- or three-year minimum term. But the proposal would apply only to GRATs established after the date of enactment of the statute.

Therein is the takeaway. It seems clear to me that if you are ever going to utilize a GRAT, the time to do it is now, before rates head back up and before the law changes. In my experience, proposals that close what Congress identifies as "loopholes," and also are revenue raisers, do not go away. They eventually find their way into some bill, even if not included in the original legislation or passed the first time.

A 10-year minimum time frame would make GRATs less attractive. The most obvious problem is that the grantor must live longer than the GRAT's term. If the grantor passes away while the GRAT still exists, all its assets are included in the grantor's taxable estate. Alternatively, if the grantor outlives the GRAT, only enough assets to constitute the principal contributed and the stated hurdle rate of return revert to the grantor to be in his or her estate, with the "excess" return staying in the trust for the benefit of future generations.

The president's "green book" contains the observation that "the greater the appreciation, the greater the transfer tax benefit achieved." This concept has led investors to populate GRATs with their most volatile assets, hoping to hit a home run and move large amounts of money to the next generation without incurring a transfer tax. If the volatility goes in the right direction, the GRAT is considered successful. If not, the investor has the same economics as without a GRAT, aside from the costs of setting it up.

Why not go for singles and doubles?

A more deliberate approach would be to fund the GRAT with assets that are "predictably" going to return more than the current 3.2% statutory rate. If the family is making a commitment to the junk bond market, maybe those assets should be placed in a GRAT. If a 14% return is achieved, everything over 3.2% is transferred to the next generation without being hit with an estate tax. If the hurdle is not bested, you're out the cost of setting up the GRAT.

I'm told that the creation of a GRAT has been commoditized enough by the legal community that setup costs aren't prohibitively expensive. This makes creating multiple GRATs on different assets more attractive; diversification in a GRAT is not optimal.

Since returns are magnified if the GRAT's term is short, stretching the holding period to 10 years produces less-than-stellar returns after the effects of averaging, even if one or two years produce great returns. After considering the likelihood of a tax change and the low-interest-rate hurdle, we think now is the time to explore using a GRAT.

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