

VALUATION observations



A GR(E)AT Time For a GRAT

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As the “Baby Boomers” reach retirement age, there are millions of individuals in the United States concerned with succession planning. One of the most effective vehicles for wealth transfer is the GRAT, which can allow beneficiaries to receive assets free of estate taxes. Already a popular tax-planning strategy for the transfer of closely-held stock, recent events and expected changes to the current landscape make GRATs all the more attractive at this time.

What is a GRAT?

A GRAT, or Grantor Retained Annuity Trust, is a revocable trust set up by a grantor to pass wealth to beneficiaries, with the intention of minimizing the associated gift taxes. The grantor transfers assets into a trust, which is established for a set term, and an annuity interest payment is paid to the grantor during each year of the term. When the term expires, the assets in the trust are passed to the beneficiaries.

a GRAT, including private equity, public common stock, cash, bonds, real estate, and others. Due to their effectiveness as a generational wealth transfer tool, GRATs are frequently formed with ownership interests in closely-held family businesses or family limited partnerships. If an interest in a privately-held company or partnership is placed in a GRAT, a business appraisal is required at the time of the initial transfer to determine the asset’s fair market value. This appraisal may be heavily scrutinized by the Internal Revenue Service, so it should be a comprehensive report prepared by a qualified valuation expert.

The most popular type of GRAT is called a “zeroed-out” GRAT, which, if completed successfully, will lead to a gift tax-free transfer of the trust assets at the end of the term. Because the taxable gift is equal to the fair market value of the property originally transferred to the trust, less the present value of the grantor’s retained an-

$$\text{GRAT Taxable Gift} = \text{Value of Property Transferred}^1 \\ - \text{Present Value of Annuity Payment}^1 \\ 1 - \text{At the GRAT's formation}$$

All types of assets classes can be placed in

(Continued on page 2)

A GR(E)AT Time For a GRAT (continued)

nunity interest, setting these amounts equal to one another leads to a tax-free gift.

Why is now the time to form a GRAT?

A GRAT will be successful as long as two conditions are met: 1) the assets in the trust earn a higher return than the prevailing IRS Section 7520 rate (the discount rate used to calculate the present value of the annuity interest, released monthly by the IRS); and 2) the grantor survives the length of the term. That being said, if either of these conditions is not met, the grantor will be in no worse of a financial position (disregarding any administrative fees associated with the GRAT). If the assets do not earn a return higher than the Section 7520 rate, the benefit of placing these assets in the trust is forfeited. If the grantor dies before the end of the term, the GRAT assets are transferred to his or her estate (as they would if no GRAT were in place). While the grantor has limited ability to control the second condition (aside from setting a reasonable term-length), she or he can give the trust the best chance of meeting the first condition by utilizing the right mix of assets and creating the trust during a time of low Section 7520 rates (since the rate is fixed at the creation of the GRAT).

Numerous factors have combined recently to make GRATs an effective wealth transfer tool.

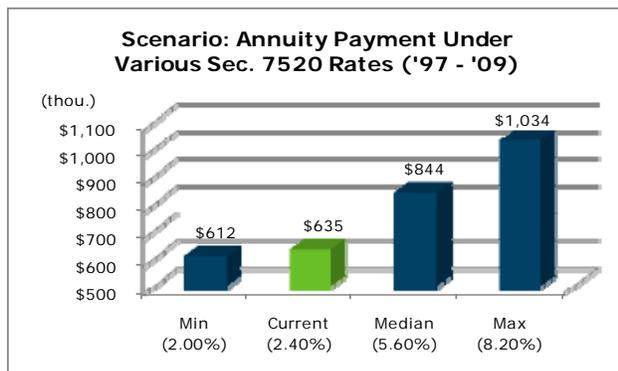
Asset values have declined significantly in the past few years, specifically real estate and equity investments. Even ownership interests in private companies may have lost value compared to a few years ago. Depressed asset values lower the required annuity interest payment, which is beneficial from the standpoint of the GRAT since it reduces the annual liquidity burden. Further, these assets may be able to rapidly appreciate as economic and financial market conditions improve. Should this situation materialize, the GRAT will likely be able to earn a higher return than the Section 7520 rate.

It is obvious that the lower the Section 7520 "hurdle rate," the better chance the assets in a GRAT have of exceeding that rate. The Section 7520 rate fell to its lowest level in over ten years in February 2009, to just 2.0%. For March 2009, the Section 7520 rate stood near the historical low-point at 2.4%. A discount rate at this low level reduces the required annuity payment. For example, let's assume a scenario where \$10 million in assets are placed in a GRAT with a 20-year term. At the current Section 7520 rate, the required annuity payment under this scenario would be \$635,000. Comparatively, the payment burden would be over \$200,000 higher under the median observed rate since 1997 (5.60%; see the

(Continued on page 3)

A GR(E)AT Time For a GRAT (continued)

accompanying chart). Therefore, it would be wise for grantor to “lock-in” the lowest possible Section 7520 rate by forming a GRAT now.



Conclusion

Aside from the reasons listed above, potential grantors have additional incentive to form a GRAT at this time. Facing a sizable and increasing budget deficit, the U.S. government is expected to revise federal tax laws under new President Barack Obama. Experts have speculated that the new administration may eliminate GRATs to raise tax revenues. As such, it would be wise to contact your attorney or valuation expert now to explore this excellent succession planning strategy... before it's too late. 

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