

VALUATION observations



A Valuable Estate Planning Tool Lost? Congress Threatens to Change GRAT Regulations

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A GRAT, or Grantor Retained Annuity Trust, is a popular estate planning tool because, with proper design, it may allow high net worth individuals to transfer wealth without paying estate or gift taxes. As business valuation professionals, we've recently observed a considerable increase in demand for valuations of shares of private companies for GRAT-related purposes. However, recent legislation passed in the U.S. House of Representatives would strip GRATs of some of their estate planning benefits. Therefore, it may be time to act now, before new GRAT regulations are passed into law.

What are GRATs, and why are they popular?

A GRAT is a type of irrevocable trust set up by a grantor to pass wealth to beneficiaries, with the intention of minimizing the associated gift (and potentially estate) 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. Numerous types of assets can be placed into a GRAT, including private equity, public common stock, cash, bonds, real estate, and others. Due to its effectiveness as a generational wealth transfer tool, GRATs are frequently formed with ownership interests in closely-held family businesses or family limited partnerships (with a business valuation required to determine the value of these types of businesses).

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GRATs are popular for their ability to lead to a gift-free transfer of trust assets

through a "zeroed-out" GRAT. 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 annuity interest, setting these amounts equal to one another enables a tax-free gift.

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The attractiveness of GRATs has been further enhanced by the current financial and economic environment. Since the value of assets placed in a GRAT is measured at its formation, and since any appreciation in these assets after the formation is not subject to estate/gift taxes, it follows that a grantor would benefit most from transferring assets that are expected to appreciate during the GRAT term. The "Great Recession" of the late 2000s depressed many asset values, and with leading economic indicators looking relatively strong in comparison, there are many types of asset that have the potential to appreciate in the near term. Specifically, mid-size, privately-held businesses tend to perform well in the expansion period following a recession. Further, the current environment has led to lower interest rates, including the IRS' assumed rate of return on the trust assets – the IRS Section 7520 rate ("Section 7520"). This is the rate used for calculating the interest on plan assets for the purpose of determining the annuity payments. Clearly, it is the intention of most grantors to minimize this annuity payment, so a lower interest rate is beneficial. The Section 7520 rate stood at 2.6% for August 2010 – for historical perspective, this rate is lower than in any month from 1997 through 2008. To quantify the benefits of this lower rate, on a \$10.0 million contribution to a four-year GRAT,

the annual annuity payment would be over \$100,000 lower under the August 2010 rate than under the average rate for 2006 through 2010 (4.3%).

What may the U.S. Government change?

In order to increase taxes to reduce the government's budget deficit, President Obama and Congress have each proposed changes to GRAT regulations. Two bills recently passed by the U.S. House of Representatives, H.R. 4899 and H.R. 5486, propose changes to GRAT regulations that would weaken their ability to be an effective estate planning tool. These bills would require that, among other things, GRATs have: (1) a minimum term of at least 10 years, and (2) a remainder interest with a value greater than zero. The term of the GRAT is important because if grantor does not survive through its end, the trust assets are placed into his/her

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estate and the tax benefits of the GRAT are relinquished.

Currently, most GRATs are formed with shorter time horizons (e.g., two

to five years) in order to improve the likelihood that the grantor out-lives the term. The second proposed legislative change, that the remainder interest must have a value greater than zero, is

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detrimental because it eliminates the potential for a gift tax-free transfer of wealth through a “zeroed-out” GRAT.

Summary

Due to the proposed revisions to GRAT regulations, as well as an environment that is currently conducive to forming GRATs (e.g., low Section 7520 rate, positive economic outlook, etc.), now may be the right time to act. Our valuation experts have extensive experience in valuing businesses and business interests for estate and tax planning purposes, as well as for financial reporting, transaction, and various other purposes. 

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