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Client Alert

Low Interest Rates and Slumping Market, a Powerful Incentive for Creation of Grantor Retained Annuity Trusts

The decline in interest rates, still close to their historical lows, now at 4.2% for the so-called Section 7520 rate (also known as the IRS “hurdle rate”), are driving the creation of short term “zeroed out” Grantor Retained Annuity Trusts (GRATs). Moreover, the decline in value of marketable securities presents another opportunity to capitalize on the possibility of shifting future appreciation in your portfolio to your children at no gift tax or estate tax cost.

A GRAT is created by the grantor transferring one or more assets with growth potential to an irrevocable trust and retaining the right to an annuity interest for a fixed term of years. When the retention period ends, the remaining assets in the trust (the income/appreciation in excess of the hurdle rate) are paid to the named “remainder” beneficiaries. When a GRAT is “zeroed out”, there is no gift tax on the creation of the GRAT since the present value of the annuity equals the value of the assets gifted to the trust.

For example, if the grantor transfers \$3 mil to a GRAT which earns 6% per year (income and appreciation), and reserves an annuity for 2 years, each year he will receive back about \$1.6 mil; and at the end of the second year, the beneficiaries will receive about \$83,000, free of gift and estate tax. If the GRAT investments had a total return of 10% per year, the grantor would receive the same annuity, but the beneficiaries would receive \$278,000, free of gift and estate tax. An even more successful GRAT earning 15% per year would yield the beneficiaries \$536,000. Hence, the larger the spread between the actual return realized by the GRAT and the hurdle rate (4.2% in the example), the more that will pass to the beneficiaries.

Research has shown that a series of short-term (say, 2 year) rolling GRATs generally outperform a single long term (say, 10 year) GRAT.

In the past 10 years, a 10 year GRAT funded with marketable securities realizing an annualized return of just 5.9% (the S&P Compound Return), funded with \$5 million, failed to transfer any wealth to the beneficiaries. On the contrary, a series of 2 year GRATs over the same period with the same investments, succeeded in 6 of the 10 years and in the aggregate transferred \$3.4 million to the beneficiaries.¹

A similar analysis was recently used by another investment firm to demonstrate that in over 67 different 12 year periods in the stock market, a 10 year GRAT was successful in transferring wealth to beneficiaries 50 out of 67 times; whereas a series of 2 year rolling GRATs created during the same 12 year periods were successful 67 out of 67 times.²

To illustrate the power of 2 year rolling GRATs: If \$3 mil is transferred to the initial GRAT, the annuity is rolled over by the grantor each year into a new 2 year GRAT, and the total investment return is assumed to be 10% per year when the hurdle rate is 5%, at the end of the 5th year when all the GRATs terminate, the creator will have received back about \$4 mil and the beneficiaries will have received \$1,400,000.

For a GRAT to be successful, it must hold assets likely to appreciate over time. Bonds and other fixed income assets should not be used; but equities, especially those that have declined recently but are expected to outperform the hurdle rate going forward, would be excellent choices.

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¹ Source: Alliance Bernstein, *Wealth Transfer Strategies* – Summer 2008.

² Source: Brown Brothers Harriman, *The Wealth Transfer Machine* -- Feb. 2006.