Limited Liability Partnership
including Professional Corporations

Brad S. Grayson
Kenneth A. Kosky, Ltd.
Joyce A. Levy, Ltd.
Arnold B. Malk, Ltd.
Benton C. Strauss, Ltd.

straussmalk@straussmalk.com
www.straussmalk.com

STRAUSS & MALK LLP
Attorneys at Law

135 Revere Drive
Northbrook, Illinois 60062
(847) 562-1400
FAX (847) 562-1422

Chicago Phone
(312) 441-0900

H. Jay Glaubinger
Michelle H. Gooze-Miller
Jeremy J. Kramer
Michael S. Strauss

Robert O. Rosenman
Of Counsel

M E M O R A N D U M

TO: Client

FROM: Strauss & Malk LLP

DATE: March 2, 2005

RE: Zeroed Out Grantor Retained Annuity Trusts

Because of a recent development in the law, an old technique is now more valuable for estate tax reduction planning. This technique is a grantor retained annuity trust ("GRAT") established in such a manor that the gift has little or no value for gift tax purposes. This is known as a "zeroed out GRAT" or a "ZOGRAT." A ZOGRAT allows for the transfer of assets to children or other designated beneficiaries potentially free of gift and estate taxes.

How a GRAT Works

A GRAT is an irrevocable trust to which you transfer appreciating assets and in exchange receive a fixed annuity payment for a term of years or months (which must be at least twelve months and one day). A gift tax on the excess of the value of the assets transferred to the trust over the present value of the fixed annuity payment is due at the time of transfer (this could be zero using a ZOGRAT). The fixed annuity payment is calculated based on the value of the principal you contribute to the trust, plus interest at the IRS assumed interest rate. Currently, this interest rate is quite low. To the extent the GRAT assets (income and appreciation) grow faster than the IRS rate, at the end of the GRAT's term the excess will pass to designated beneficiaries, without further gift or estate taxes. In addition, obtaining a discount on the assets to be transferred to the GRAT can result in even more passing to the designated beneficiaries at the end of the term.

The GRAT is a "grantor trust," because it may use income or principal to satisfy the fixed annuity payments. This means that all items of income and deduction will be reported on your Form 1040, and you would pay all taxes on this income.

Risks that exist in creating a GRAT to reduce estate taxes include (1) your death during the GRAT's term, in which case the transaction does not reduce estate tax, (2) the contributed assets failing to appreciate as expected, or (3) the IRS challenging the valuation of the transferred assets. In the event that you should pass away during the term of the GRAT, the remaining assets in the GRAT are included in your estate for estate tax purposes. However, if the GRAT is not created, these assets would be included in your estate anyway. If the growth in asset value does not exceed the IRS rate, then nothing will pass to the designated beneficiaries at the end of the GRAT's term; but again because you have paid no transfer tax, this is a small risk. Therefore, except for the risk of an IRS challenge to valuation, the cost of doing the transaction is the lost opportunity of implementing another wealth shifting plan. GRATs are a relatively low risk technique for transferring wealth.

Depending on the assets transferred to the trust, we may recommend creating a series of short-term GRATs as opposed to a single long-term GRAT. The benefits of a series of short-term GRATs (such as two years each) are that there is less risk of death during any of the shorter GRAT terms and that losses in one year in the GRAT would have less risk of offsetting gains in other years. These factors should help compensate for the fact that a longer-term GRAT could lock in the currently low IRS rates over a longer period.

What is a ZOGRAT

A ZOGRAT is a variation on the GRAT discussed above. The difference is that the ZOGRAT provides for the fixed annuity payment to be sufficiently high to cause the present value of the gift to the designated beneficiaries to be zero, and therefore results in no taxable gift. However, as with a traditional GRAT, all excess growth in the assets would still pass to your designated beneficiaries. The key is that in order for there to be property remaining in the ZOGRAT at the end of the term, the assets in the ZOGRAT must grow at a rate in excess of the IRS rate used to value the present value of the fixed annuity payment.

Example: An individual sets up a two-year ZOGRAT with shares of stock expected to appreciate at 10% per year, and valued at $1,000,000 at the time of transfer. If the transfer was made this month, when the IRS interest rate is 4.6%, the grantor would receive two annual payments of approximately $535,000 each, resulting in total payments of $1,070,000 (these payments may be made in stock). Approximately $87,000 would pass to the designated beneficiaries at the end of the two years, free of gift and estate taxes.

If this was closely held stock or real estate, and a discounted valuation of $800,000 could be obtained (assuming a 20% discount), then the payments to the grantor would be approximately $430,000 per year, resulting in total payments of

$856,000. Then, approximately $312,000 (in undiscounted assets) would pass to the designated beneficiaries at the end of the term, free of gift and estate taxes, with the risk being that the IRS disagrees with the discount applied to the assets or their valuation.

We recommend that the GRAT or ZOGRAT be planned to result in a very small gift, such as $100, to require the filing of a gift tax return and therefore run the statute of limitations on the transaction.

For many years, the IRS contended that it was impossible to zero-out a GRAT. This made the GRAT technique described above only useful in limited situations. However, the IRS has recently acknowledged that a ZOGRAT is permissible, and this has created new planning opportunities which we and many other practitioners are now using.

Please contact us if you would like to discuss this further.