

# VALUE ADDED™

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## Grantor Retained Annuity Trusts

### How to be a More Cheerful Giver

A Grantor Retained Annuity Trust, also known as a GRAT, is not a new estate planning tool but it occasionally merits revisiting, especially when interest rates are declining. The reason for this will be explained below, but let us begin by reviewing the basics of GRATs; how they are structured and what benefits they provide if properly implemented.

GRATs are complex estate planning vehicles. It is not the intent of this article to discuss every facet of their usability, but to focus on their basic concept and the role of the business appraiser in the process of establishing a GRAT.

A GRAT is a trust which is authorized by Chapter 27, Section §2702 of the Internal Revenue Code which allows a grantor to transfer property into a trust for the benefit of a family member,

for a specified period of time, while retaining an annual annuity payment. The underlying basis for the establishment of a GRAT is twofold:

- Gift taxes are based on the value of the gift to the donee and the gift (and the resulting gift tax) must be discounted by the cost of waiting. The longer the wait, the lower the gift tax value of the asset placed in trust and the lower the cost of the gift. The level of interest rates is also important because the gift tax is based on the difference in the fair market value of the asset placed in trust and the present value of the annuity or the retained interest. The lower the discount rate applied to the annuity, the higher the present value and conversely, the higher the discount rate the lower the present value. (Interest rates are specified monthly by the IRS under Section §7520 actuarial tables).

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## Calculation of Damages An Appraisal Perspective

Business valuation professionals are frequently engaged to quantify, support and/or challenge damages in matters arising from the normal course and extraordinary circumstances of business activity. Disputes between plaintiffs and defendants can develop into legal action that requires professional business valuation expertise in order to quantify a plaintiff's claim or to challenge a defendant's liability (if any). Given the agenda of opposing legal counsel and the adversarial nature of litigation, appraisers should be prepared to objectively defend their conclusions

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- Generally, the federal estate tax does not reach a property interest (or the asset contributed) unless the decedent owned it when he died. If the grantor lives beyond the specified period of the trust, he no longer owns the property and, therefore, upon death it escapes estate taxation.

Perhaps the first basis for establishment of a GRAT is best illustrated by an example. In this example, the objective is to minimize gift taxes by minimizing the difference in the fair market value of the asset contributed to the trust and the present value of the remainder or the annuity.

Mr. I. M. Overtaxed places his ownership of closely held stock valued at \$750,000, in a GRAT for the future benefit of his son ("the remainderman") and retains an annuity of 10% for 10 years. The calculation of his gift subject to gift tax is presented in Table 1. (*Two different interest rate scenarios are presented to reflect the impact and importance of the level of interest rates.*)

The discount rates selected are those stipulated by the IRS tables for July, 1995 (7.6%) and December, 1994 (9.4%), thus illustrating the difference in the amount of the taxable gift at various rates. The grantor has made a gift with a \$750,000 value and is subject to gift taxes on \$277,035 if a discount rate of 9.4% is applicable and \$237,540 at a discount rate of 7.6%. It should also be noted that the gift tax liability can be offset by the grantor's \$600,000 unified gift and estate tax exemption.

The second basis for establishment of a GRAT is based on the survival of the grantor over the period of the trust. The full benefits of a GRAT are only achievable if the grantor survives the full term of the trust. If he outlives the specified term, the trust's assets should not be included in the grantor's estate because the grantor has retained no interest in the trust assets at death. In the case of an elderly owner or client, (i.e. one with a higher risk of not being able to take advantage of the full benefit) staggered trust transfers are sometimes used, transferring only a portion of assets for five and ten year periods, respectively.

There are other significant issues which are beyond the scope of this article that must be addressed before a GRAT is established. Such issues include: the taxation of the retained interest, the tax implications of death prior to the term of the GRAT, restrictions on the interest transferred, the size of the interest transferred, the potential for appreciation of the assets transferred and the future tax implications to the remainderman and the value of the property transferred.

One of the keys to a successful GRAT transfer is the determination of the fair market value of the asset being transferred into the trust. Although a variety of assets can be used to fund these types of trusts, it is not uncommon to transfer stock in closely held compa-

nies. In the case of S-corporation stock, the company is typically already providing income to the owner which may be considered an annuity. In all cases, a correct valuation of the stock is critical. If a shareholder is transferring a minority interest, an independent valuation with reasonable minority interest and marketability discounts may allow the shareholder to remove a greater number of shares from the estate to fund the GRAT.

In addition, there is a statute of limitations on the revaluation of gifts for gift tax purposes (See *The Government May Revalue Gifts for Estate Tax Purposes*, VALUE ADDED™, 1994), but the statute of limitations does not apply if the grantor does not pay a gift tax because the unified credit is applied.

The best way to prevent the IRS from questioning stated value is to obtain an independent, soundly reasoned valuation that provides evidence that the value of the transfer is what the grantor claims it to be at the time of the transaction. This may avoid having the IRS assign a value years later, when the grantor is deceased and the factors which influenced value at the time may be difficult to determine.

There is no guarantee that the IRS, at some later point, will not argue that the gift value was understated, but as they say "the best defense is a good offense." Document your position with a qualified independent appraisal. It will certainly place you in a stronger position if the question arises. ♦

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TABLE 1

Fair Market Value of Asset to be Placed in Trust	\$750,000	\$750,000
Annual Annuity Payment @ 10% = \$75,000		
Less: Present Value of \$75,000 for 10 Years @ 9.4%	(\$472,965)	
Less: Present Value of \$75,000 for 10 Years @ 7.6%		(\$512,460)
Remainder Interest - Amount of Taxable Gift @ 9.4%	\$277,035	
Remainder Interest - Amount of Taxable Gift @ 7.6%		\$237,540

Source: Revenue Ruling 94-73, Tables, Rate Under Section 7520 for 12/94  
Revenue Ruling 95-48, Tables, Rate Under Section 7520 for 7/95  
Assumes annuity payments made once a year at year-end

## Calculation of Damages

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and the underlying components used in developing them. As with all business valuation assignments, appraisers must have a solid grasp of all critical assumptions from both sides of the aisle. A well-prepared valuation expert can anticipate how changes in those assumptions will affect conclusions.

Keeping in mind that the realm of potential engagements is beyond any list, business appraisers are typically engaged in damages suits involving the following situations and occurrences.

- Breach of Contract
- Condemnation
- Lost Business Opportunity
- Lost Profits
- Antitrust
- Personal Injury
- Insurance Casualty Claims
- Wrongful Termination of a Franchise

In many litigated damage situations, a plaintiff is charged with the burden of proving that the defendant's action's were the *proximate cause* of the claimed damages, that damages were, with *reasonable certainty*, actually incurred (or worsened as the case may be) as a result of the defendant's actions, and in contract disputes that such damages were a *foreseeable consequence* of the defendant's actions. These are matters of legal interpretation.

In most cases, business valuation professionals are called into service subsequent to the determination of legal exposure in order to help resolve the remaining question of magnitude.

The methodological approaches used to calculate damages vary with circumstance. In most cases there are substantial assumptions required in the construction of financial models. Most business valuation texts group the major methods of damage calculations under three general categories (1) the "before-and-after" approach; (2) the "yardstick" approach; and, (3) the "sales projections" approach (also referred to as the "but-for" or "hypothetical profits" approach). Damage claims are often calculated

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using the method best suited to take advantage of all available information. Claims that do not factor in the totality of information resources are more susceptible to an opposing expert's scrutiny.

The before-and-after method is best applied when adequate historical information (preceding the alleged acts) is available for comparison to the reported information and/or anticipated performance postulated after the alleged acts.

The yardstick (sometimes referred to as "comparable") approach is often used in cases where ample information on similar businesses exists such that an expert can formulate an expected level of performance likely to have been achieved if the alleged damages had not occurred. The most critical factor in this approach, as with "guideline" based appraisals in

other valuation arenas, is the selection of companies with close alignment to the subject. Additionally, an overview of the subject's industry and market are likely to be vital in making assumptions about reasonably attainable performance.

The sales projections method relies upon modeling the damaged party's business in such a manner as to create a pattern of performance that would have occurred but-for the alleged damages. This method is probably the most relied upon approach in calculating damages. It is generally beneficial to use when the subject has consistently used forecasts and budgets in the normal course of business planning and has a track record of achieving its projected performance.

Regardless of the method(s) used to calculate damages, appraisers state their conclusions to reflect the present value of past and future damages. Opposing parties can be close in their estimations of lost profits or earnings during the period in which damages occurred but differ greatly in the application of discounting and compounding techniques in restating

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### SPEAKERS' BUREAU

Members of this firm often participate in local and national speaking engagements, which include group seminars and speeches for attorneys, CPAs, CEOs, and other financial advisory professionals interested in topics relating to Business Valuation. Please call for further information or to discuss a specific speaking engagement.

## Calculation of Damages

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damages to present value terms. Parties on both sides must be aware of the rates applied and be sure that consistency is maintained throughout all analyses. There can be significant difference of opinion among valuation experts as to appropriate rates for time value calculations and many jurisdictions have statutory requirements that establish applicable rates. The appraiser must test the sensitivity of all conclusions to the range of rates applied on both sides.

Parties involved in damage suits routinely fail to achieve a firm grasp of the complex issues required to develop and/or defend claims of damage. As a subject in any damage suit, companies and individuals as well their legal counsel can find themselves overwhelmed by the sheer size and number of trees in the forest. In most cases, a business valuation expert can help. We would be pleased to discuss such matters in confidence with you. ♦

## Year-End is Upon Us Are You Ready?

It's not too late to begin thinking about year-end and those projects and transactions that should be accomplished by then. Some year-end projects have been in the planning stage for years, some since last year-end and some for many months. Still others come up at the very last minute.

Since some people are already starting to call, we thought a friendly reminder to try to anticipate the appraisal requirements that will be a part of the year-end transactions you or your clients are planning would be useful. If such appraisal requirements are likely to exist, it is a great idea to get your appraisers working right away. It's always preferable to deal with unanticipated appraisal issues without a deadline aimed like a gun at your head!

What kinds of transactions are we talking about?

- **Gifts of closely held stock.** If you or your clients are planning to make substantial gifts to children,

other relatives or to charity this year, *qualified independent appraisals will be required.*

- **Purchase or sale of stock among or between related parties.** Related parties may include the family, the owners of a closely held business, or members of a company's management team. Appraisals are often required to substantiate the fact that transaction prices are "arms' length" in nature.
- **Fairness opinions related to transactions.** In the rush to complete transactions, the minority shareholders of companies, who are not present at the bargaining table, may need "representation" in the form of an independent review of the financial fairness of the transaction. When issues of fairness are involved, the length of time the financial advisor has to conduct his/her analysis can be important — longer lead times are always preferable to shorter lead times.
- **All other year-end transactions, which take many forms.**

Please call us as early as possible with your business appraisal requirements. We stand ready to help you with your year-end needs. ♦

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