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Grantor Retained Annuity Trust (GRAT)

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What is it?

A grantor retained annuity trust (GRAT) is an irrevocable trust into which a grantor makes a one-time transfer of property, and in which the grantor retains the right to receive a fixed amount (an annuity payment) at least annually for a term of years. At the end of the term of years, any remaining property in the GRAT passes to the remainder beneficiaries (typically the grantor's children) or is held in trust for their benefit. A GRAT is a way for the grantor to transfer property to heirs, but it also has the potential to minimize federal gift and estate tax .

Potential tax advantages of a GRAT include:

- The tax value of the gift is reduced. The present value of the grantor's retained interest is subtracted from the total value of the transferred property when determining the amount of the gift to the remainder beneficiaries for gift tax purposes. The gift is "discounted" using a calculation based on the IRS' assumed rate of return in effect during the month the gift is made (this is known as the Section 7520 rate, hurdle rate, or discount rate). Any gift tax due can be offset to the extent of the grantor's available gift and estate tax applicable exclusion amount (which in 2014 is $5,340,000 plus any deceased spousal unused exclusion amount). However, a GRAT can be structured so the retained interest is equal to the value of the transferred property, in which case there are no gift tax consequences (this is referred to as a "zeroed-out GRAT").
- Property transferred to a GRAT will not be included in the grantor's gross estate as long as he or she outlives the term of the retained interest. If the grantor dies before the term of the retained interest ends, however, the full value of the property in the trust on date of death will be included in the grantor's gross estate for federal estate tax purposes.
- Appreciation in (and/or earnings generated by) the property after being transferred to the GRAT will also not be included in the grantor's gross estate. This tax benefit is most advantageous for grantors who own rapidly appreciating property or high income-producing property, especially during periods when the Section 7520 rate is low.

Example(s): *Joe transfers property valued at $1 million into a GRAT that will pay him $117,000 at the end of each year for 10 years. The Section 7520 rate at the time is 3.0 percent (i.e., the IRS anticipates that the property will grow at this rate). The retained interest is valued at $998,033, and the taxable gift to the remainder beneficiaries is valued at $1,967. Joe pays gift tax on $1,967 (or offsets this amount with his available gift and estate tax exemption).*

As explained above, a GRAT can minimize gift and estate tax, but only if it is successful. For a GRAT to be successful at all, the grantor must outlive the term of the GRAT, and the property in the GRAT must outperform the Section 7520 rate. If the GRAT is not successful, though, the grantor is in some ways no worse off than he or she was before creating the GRAT. Even if the grantor dies before the term of years ends, all the property in the trust is included in the grantor's estate for estate tax purposes, just as it would have been had the GRAT not been created. And, if the return on the property transferred to the GRAT is equal to or less than the Section 7520 rate, there is no excess to transfer and no tax savings is achieved. But, there are risks associated with an unsuccessful GRAT, which include:

- Wasting any costs incurred to create and maintain the GRAT
- Wasting any grantor's applicable exclusion amount that is used (though the amount should be minimal)
- Paying gift taxes on property that returns to the grantor (though the amount should be minimal)

Tip: *With a GRAT, the grantor receives a fixed dollar amount that does not change even if the value of the trust property (corpus) increases or decreases. With a grantor retained unitrust (GRUT), a grantor may, instead, retain the right to receive a* fixed percentage *of the trust corpus, determined annually.*

When can it be used?

A GRAT generally works best for people who are expected to outlive the specified term of years, and who have enough other property to maintain their lifestyle when the annual payments stop.

Further, a GRAT should be considered if:

- The grantor has property that is expected to appreciate significantly in the short term
- The grantor has property that has the potential to outperform the Section 7520 rate

- The grantor does not want to pay federal gift tax and has already used up his or her applicable exclusion amount
- The grantor has suitable property for a GRAT, such as closely-held stock (especially pre-IPO), family limited partnership (FLP) interests, high growth investment portfolios, and commercial real estate.

Strengths

Use of GRAT may allow transfer of property to beneficiaries to be discounted for federal gift tax purposes

Transferring property to a GRAT is considered a taxable gift to the remainder beneficiaries. However, since the grantor retains a valuable interest and the remainder beneficiaries of the GRAT will not receive the remaining trust property until some time in the future, the IRS generally allows the grantor to discount the value of the gift for gift tax purposes. The size of the discount depends on the length of the term of years, the annuity payment amount retained by the grantor, and the applicable Section 7520 rate. The longer the term of years, the higher the annuity payment amount, and the lower the Section 7520 rate, the more the value of the gift may be discounted. In fact, a GRAT can be structured so that there is no taxable gift. This is known as a "zeroed-out" GRAT.

If there is a taxable gift, however, gift tax due may be offset by the gift and estate tax applicable exclusion amount, to the extent it has not already been used up by the grantor.

Caution: *The grantor's retained interest will be valued at zero if the GRAT does not meet the requirements of Section 2702 of the Internal Revenue Code, resulting in a taxable gift equal to the entire value of the transferred property. For example, the GRAT document must state that the grantor retains the right to a fixed annuity payment for a specific term of years, for life, or for the shorter of these two periods. Because it must be precise, the GRAT document should be drafted by an experienced estate planning attorney.*

Caution: *If the grantor lives in one of the handful of states that impose their own gift tax, state gift tax may also be due.*

Value of property remaining in GRAT will not be included in grantor's gross estate as long as grantor outlives the term of years

As long as the grantor outlives the term of years set out in the trust document, the property (principal and interest) remaining in the trust will not be included in the gross estate of the grantor for estate tax purposes. The grantor need only outlive the term of years for one day. Thus, a GRAT can be an excellent vehicle for transferring future appreciation in excess of the Section 7520 rate gift and estate tax free. A GRAT can be especially valuable to a grantor who has property that is expected to rapidly appreciate or produce high earnings.

Use of GRAT may prevent will contest, public scrutiny of assets, or an election against will

Property transferred to a GRAT will not be part of the grantor's probate estate. The property will be distributed to the remainder beneficiaries named by the grantor according to the terms of the trust. The grantor's other legal heirs would have no claim to them, and this may discourage a will contest . Furthermore, a will is a public document. Anyone can go to the probate court and view the contents of a will. A trust, however, is a private document that is not subject to public scrutiny. Finally, in most states, certain heirs (usually a spouse and children) have the right to a percentage of a probate estate no matter what has been left to them in the will. However, property transferred to a GRAT is not part of the probate estate and thus not subject to an election against the will .

Tradeoffs

Property in trust will not escape estate taxation if grantor does not outlive the term of years

Failing to outlive the term of years throws the trust property back into the grantor's estate, and the advantages of the GRAT will be lost.

Tip: *To provide for this contingency, many estate planners recommend that the remainder beneficiaries of the trust purchase a life insurance policy on the grantor for the term of years. Then, if the grantor dies too early, the beneficiaries will have the funds to pay* *the estate taxes.*

Transfer of property to GRAT is a taxable gift

Since a GRAT is set up as an irrevocable trust, a transfer of property to the trust is considered a taxable gift to the remainder beneficiaries. Therefore, federal gift and estate tax may have to be paid if the amount of the taxable gift is above the applicable exclusion amount (which in 2014 is $5,340,000 plus any deceased spousal unused exclusion amount) or if the grantor's exclusion amount has been previously used.

Transfer of property to GRAT does not qualify for annual gift tax exclusion

A transfer of property to a GRAT does not qualify for the annual gift tax exclusion . To qualify for the annual gift tax exclusion, the donees (i.e., recipients) must have a present interest in the gift (i.e., the donees must be able to currently possess, use, and enjoy the gift). However, with a GRAT, the remainder beneficiaries will not have a present interest in the property until the grantor's retained interest ends at some point in the future.

Property in GRAT will not be available to the grantor during the term of years

As with any other irrevocable trust, once property is transferred to a GRAT, the grantor gives up control over it. If circumstances change during the term of the trust, and the grantor finds that he or she needs more than the annuity payment amount, he or she will be unable to access the property in the GRAT.

Grantor will lose annuity from GRAT at end of specified term

Once the specified term ends, the grantor's retained interest ends and the trust property passes to the remainder beneficiaries (or it can remain in trust for their benefit). If the grantor outlives the specified term and still needs the income, he or she will be unable to access the property in the GRAT.

Cost of creating GRAT may be wasted if GRAT is unsuccessful

There may be costs incurred to create and maintain a GRAT. First, a competent and experienced estate planning attorney will be needed to draft the trust document. Second, the attorney will have to transfer and retitle the transferred property in the name of the GRAT. Finally, the transfer of property to a GRAT is considered a taxable gift. Gift tax returns will need to be prepared and filed, and gift taxes may need to be paid. If the GRAT is unsuccessful (because the grantor does not outlive the GRAT term of years or the rate of return earned by the trust property does not exceed the Section 7520 rate), these costs will be incurred for nothing.

Gift tax paid or exclusion amount used (however minimal) may be wasted if GRAT is unsuccessful

If the return on the property transferred to the GRAT is equal to or less than the Section 7520 rate and grantor receives all the principal back plus all the earnings, the grantor will be returned to the same position he or she would have been in without the GRAT (i.e., no gift will have taken place). However, at the time of the transfer, the grantor may have paid gift tax or used a portion of his or her exclusion amount to offset gift tax due (though these amounts would be minimal). In this case, the gift tax will not be refunded, nor will the exclusion amount used be restored.

Tip: *This is not the case if the GRAT is unsuccessful because the grantor does not outlive the term of years. In that case, the full value of the property the GRAT holds will be included in the grantor's gross estate. If some or all of the grantor's exclusion amount was used to offset gift tax due when making the transfer, that part of the exclusion amount will be restored to the grantor's estate. Therefore, the personal representative of the grantor's estate can use the restored exclusion amount to protect an equal amount of property from federal estate tax. Similarly, if gift tax was paid, it will be deducted from any estate tax due.*

GRAT not generally appropriate for generation-skipping transfers

The federal generation-skipping transfer (GST) tax (and perhaps state GST tax as well) will apply to transfers of assets made to a GRAT if some or all of the remainder beneficiaries are two or more generations below the grantor (these are known as skip persons). However, the transfer does not occur until the grantor's retained interest terminates. Thus, the grantor cannot allocate his or her GST tax exemption to the transfer until the end of his or her retained interest (or estate tax inclusion) period (this is known as the estate tax inclusion period or "ETIP" rule). Allocating the GST tax exemption when the trust property has already appreciated fails to leverage the exemption. Thus, a GRAT may not be an appropriate device for making transfers to skip persons.

Tip: *A grantor may be able to circumvent these generation-skipping transfer limitations if the remainder beneficiaries sell the remainder equivalent to a dynasty trust. This remainder sale strategy is a sophisticated estate planning technique and beyond the scope of this discussion. An experienced estate planning attorney should be consulted.*

Income tax consequences of GRAT

GRAT considered a grantor trust for income tax purposes

For income tax purposes, a GRAT should be a grantor trust. Being classified as a grantor trust means that all items of income and deductions flow through to the grantor. This is the case even if all of the income earned by the trust property is not distributed to the grantor. Thus, the grantor should have other property available to meet this liability.

Remainder beneficiaries do not receive a step-up in basis

Unlike property received because of the death of the transferor, property transferred to the remainder beneficiaries does not receive a step-up (or step-down) in basis. However, this situation can be averted if the grantor buys the trust property at the end of the retained interest period. The remainder beneficiaries get the cash instead, and the property will receive the step-up in basis at the grantor's death.

What is a short-term rolling GRAT?

A rolling or cascading GRAT is a technique that involves creating a series of short-term GRATs (typically two or three years) with each successive GRAT being funded by the annuity payments from the previous ones. This technique can minimize the risk of the donor dying during the GRAT term, and can also minimize interest rate risk. During a fluctuating market, the donor with a rolling GRAT can catch a market rally whenever it occurs. If the market does not go up at all during the GRAT period, all of the GRAT is paid back to the donor, but if the market does go back up, the donor is able to take advantage of the increase. Further, whether a short-term GRAT is established during a low- or high- interest rate period, chances are that over time the rate factor will cancel itself out. Thus, rolling GRATs can provide an ideal vehicle for single stocks (or stocks of a single style, such as growth stocks), especially if they're segregated in separate trusts--an asset-splitting strategy that can work in both good and bad markets.

Caution: *Recently, Congress has been considering changing the minimum period for a zero-tax GRAT to 10 years instead of the current two.*

IMPORTANT DISCLOSURES

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