CHAPTER 75

Grantor Retained Annuity Trusts

HENNA SHAH (Fort Lee, New Jersey)

A grantor retained annuity trust (GRAT) is an advanced planning technique that can transfer significant wealth with little or no federal gift tax consequences. A GRAT can also reduce potential estate tax liability because it freezes the value of contributed property upon its transfer to the trust, thereby removing future appreciation on that property from the estate. GRATs are created by statute and have little risk of not being recognized by the IRS.

HOW GRATS WORK

A GRAT is an irrevocable trust to which a grantor contributes assets that are likely to have significant earnings or appreciation and in which the grantor retains a qualified annuity interest (in compliance with Internal Revenue Code Section 2702) payable at least annually for a specified term of years. Assets that are suitable for contribution include business interests, securities, real estate (subject to local real estate transfer tax issues), and other investments. The annuity amount is calculated by reference to an interest rate published monthly by the IRS (the Section 7520 rate). A key factor is deciding the GRAT term — usually based on the grantor's life expectancy and the time frame in which the contributed assets are expected to achieve optimum performance.

In order for a GRAT to be successful, GRAT assets must outperform the Section 7520 rate. Accordingly, GRATs are generally more attractive when the Section 7520 rate is low. If GRAT assets earn and/or appreciate at a rate that exceeds the Section 7520 rate, there will be assets available for distribution to beneficiaries of the GRAT upon the expiration of the GRAT term. If GRAT assets fail to outperform the Section 7520 rate, beneficiaries will not receive anything at the end of the GRAT term and the grantor will be in the same position as if the GRAT had never been created (less funds expended in forming and administering the GRAT). If the grantor dies before the end of the GRAT term, the grantor's estate will include the amount of GRAT assets necessary to produce the annual annuity without reducing or invading principal, as determined using the Section 7520 rate in effect on the date of death or on the alternate valuation date.

If GRAT assets have not achieved their full potential upon the expiration of the GRAT term, the grantor can contribute those assets to a newly formed GRAT. Alternatively, the grantor may wish to establish several GRATs funded with different types of assets in order to optimize the appreciation potential of each unique asset.

> **EXAMPLE 1:** Assume you own 25,000 shares of XYZ Company stock valued at $40, for a total fair market value of $1,000,000. You believe the stock is likely to appreciate within the next two years. You form a GRAT with a two-year term for the benefit of your child and transfer all 25,000 shares of XYZ Company stock to the GRAT when the Section 7520 rate is 4%. Based on these facts, your optimum annual annuity payout amount is equal to 53% of the value of the initial asset contribution, or $530,000. (In order to zero out the gift, the payout percentage must be 53.01943%. Rounding the payout percentage down to 53% results in a nominal taxable gift of $367). If the value of XYZ Company stock increases by 10% annually, at the end of the GRAT term, you will have received back $1,060,000 and $97,000 will be available for distribution to your child tax-free.

> **EXAMPLE 2:** Using the same facts as in Example 1, assume instead that the value of XYZ Company stock increases by 20% annually. At the end of the GRAT term, you will have received back $1,060,000 and there will be $274,000 available for distribution to your child.

> **EXAMPLE 3:** Using the same facts as in Example 1, assume instead that the value of XYZ Company stock increases by 3% annually. At the end of the GRAT term, you will have received back $1,045,000 and no funds will be available for distribution to your child. This result stems from the fact that the appreciation in the value of the stock did not exceed the Section 7520 rate of 4%.

> **EXAMPLE 4:** Using the same facts as in Example 1, assume instead that the value of XYZ Company stock decreased over the period of the GRAT term. You will receive back your initial contribution amount, reduced by the decrease in the value of the stock, and no funds will be available for distribution to the beneficiaries.

TAX CONSEQUENCES

Gift Tax: GRATs are designed to take advantage of the rule that imposes a gift tax on transfers to the extent that the fair market value of the property transferred exceeds the value of the grantor's retained annuity interest. By providing for the grantor's

retained annuity interest amount to be equal or close to the value of the contributed assets (as adjusted by the Section 7520 rate), the taxable gift can be zeroed out or at least minimized. Future appreciation on the contributed assets is not included in determining the value of the taxable gift.

Income Tax: For income tax purposes, the grantor is treated as the owner of all of the assets in the GRAT during the GRAT term. Accordingly, income earned on any GRAT asset during the GRAT term is taxable to the grantor. Any transfers between the grantor and the GRAT (such as when assets are contributed to the GRAT or annuity payments are made to the grantor) during the GRAT term are not taxable for income tax purposes.

CONCLUSION

GRATs are an excellent tool for freezing the value of assets and transferring appreciation out of a grantor's estate with minimal federal transfer tax consequences. Additionally, GRATs can be combined with other estate planning techniques to result in even greater tax savings.

Shah Law is a boutique estate planning firm focusing on family wealth transfer, asset protection, tax minimization, and business succession matters.

Grantor-Retained Interest Trusts

	GRAT	GRUT	QPRT
Grantor's Retained Interest	Fixed % of the initial value of the assets for a term of years.	Fixed % of assets as valued annually for a term of years.	Use of a personal residence retained for a term of years.
Value of the Gift	Remainder interest after deducting the value of the retained annuity.	Remainder interest after deducting the value of the retained unitrust.	Remainder interest after deducting the value of the retained use interest.
Annual Exclusion Amount	None. Remainder is a future interest.	None. Remainder is a future interest.	None. Remainder is a future interest.
Amount Included in Grantor's Gross Estate	Grantor survives the term of the trust: None. Grantor dies during term of the trust: A portion of trust assets.	Grantor survives the term of the trust: None. Grantor dies during term of the trust: A portion of trust assets.	Grantor survives the term of the trust: None. Grantor dies during term of the trust: Full amount of trust assets.