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GRANTOR RETAINED ANNUITY TRUSTS (GRATS)

GRATs Allow Transfer of Wealth Outside Your Estate with Minimal or No Gift Tax

Now is a good time to consider wealth transfer strategies that remove assets from your taxable estate. A common strategy is a grantor retained annuity trust, commonly referred to as a GRAT.

Description. A GRAT is a strategy that freezes the value of an asset in your estate and transfers the appreciation of the asset to your beneficiaries. In a typical GRAT, you transfer property to a trust and retain an annuity payment for a fixed term. The annuity payment is designed to roughly equal the value of the property transferred to the trust and create a nominal taxable gift (a “zeroed-out” GRAT). At the end of the term, any appreciation in the transferred property in excess of the annuity payments passes to your children or other family members (called the “remainder beneficiaries”) gift-tax free. Now is a good time to consider a GRAT because the IRS rates (the rate used to determine the annuity payment) are near historic lows and many assets have declined in value.

Example. In a month when the applicable discount rate is 0.6%, Sam transfers publicly traded securities worth \$1,000,000 to a GRAT, receiving in return a \$103,329 annuity for 10 years. Under the 0.6% discount rate then in effect, the value of Sam’s retained annuity stream is \$999,999 and the value of the taxable gift is about \$1. If the transferred property produces an average annual return of 0.6% or less, nothing will be transferred to the remainder beneficiaries at the end of 10 years. On the other hand,

if the property produces an average annual return of greater than 0.6% and Sam survives the 10-year term, property will be transferred to the remainder beneficiaries free of gift tax, as shown in the following chart:

Average Return for 10 Years:	Amount Passing Gift Tax-Free to Remainder Beneficiaries
0.6%	\$0
3.0%	\$ 159,363
5.0%	\$ 329,231
7.0%	\$ 539,509
10.0%	\$ 946,941

Suitable Property for a GRAT. The ideal assets to place in a GRAT are those with high-growth or income-producing potential. In the current economic environment, this means that most individuals could consider a GRAT for marketable securities. As in the past, a GRAT is also particularly useful as a repository for hard-to-value assets such as closely held stock, real estate or family partnership units – especially if discounts are available to lower the fair market value of the property.

One Unique Benefit of a GRAT. During a period of uncertainty when asset values are fluctuating wildly, GRATs offer a unique “no lose” feature. In the example above, Sam would assume a downside risk if he instead made an outright gift of his \$1,000,000 portfolio because if the market value of the portfolio were to

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decline to \$600,000, he would have wasted \$400,000 of his federal gift tax exemption. With a GRAT, however, the \$600,000 of assets would simply be returned to Sam, and, if he chose to do so, he could create another GRAT using the lower values. His total cost would be any legal and accounting fees incurred, plus the \$1 of federal gift tax exemption used.

Rolling GRATs. Generally, the minimum initial term for a GRAT is 2 years. A major benefit of a short term GRAT is that any failed GRATs are simply discarded and any successful GRATs produce excellent tax benefits without being encumbered by down years in the economy. One technique for maximizing value to the beneficiaries, therefore, is to create a series of short-term “rolling GRATs” -- every year that the individual receives the annuity payment, the annuity payment is used to create a new GRAT.

End-Loaded GRATs. The tax regulations specifically authorizes the use of a GRAT with smaller annuity payments in the beginning and larger annuity payments as the term continues. By “end-loading” the annuity payments, the grantor leaves more assets in the trust in the early years which may result in a greater return for the remainder beneficiaries.

GRAT RISKS AND ISSUES

1. Mortality. If you die during the term of your GRAT, the GRAT property is brought back into your estate. Of course you are in no worse position than if you had not

created the GRAT in the first place, other than the legal and other fees associated with preparing the GRAT.

2. Continuing Trusts After Initial Term of GRAT. Many clients, especially those with younger children, create continuing trusts (set forth in the GRAT itself or in a separate trust agreement) to hold the assets for the remainder beneficiaries until later ages. For “rolling GRATs,” for example, you could create an irrevocable trust for the benefit of your family that would always receive the remainder assets at the end of every successful GRAT. Although there is no downside to this approach, there may be additional legal fees associated with preparing a separate trust agreement.

3. Filing a Gift Tax Return. You must file a federal gift tax return for the year a GRAT is created reporting the future gift to the remainder beneficiaries, however small.

4. Allocation of Generation-Skipping Transfer (“GST”) Tax Exemption. A GRAT is not an effective vehicle for transferring wealth to grandchildren and later descendants through GST tax planning.

SUMMARY

GRATs are expressly permitted under the Internal Revenue Code. If they fail, you incur only a minimal tax cost and the professional fees associated with the project. If they succeed, you can transfer significant wealth to your beneficiaries, essentially gift-tax free.