Grantor Retained Annuity Trust (GRAT)

In brief

What is a Grantor Retained Annuity Trust?

- A grantor retained annuity trust (GRAT) is an estate planning technique intended to allow an individual – the grantor – to transfer assets to beneficiaries at a reduced gift tax cost.
- The grantor creates an irrevocable trust and transfers assets to it. The grantor retains an annual annuity for a fixed number of years. At the end of the term, any remaining assets pass to the remainder beneficiaries named in the trust document.

Why create a GRAT?

- **Reduced gift tax value.** Because the grantor retains an interest in the trust assets, the grantor's gift is the fair market value of the assets transferred less the present value of the retained annuity payments. For example, let's say the grantor gives property with a fair market value of $500,000 to a GRAT, but retains an annual 8% annuity ($40,000) for 10 years. If this annual payout of $40,000 (annuity) has a present value of $350,000 (calculated by using an interest rate determined by the I.R.S.), the amount of the gift is $150,000.
- **Transfer of appreciating assets.** All the assets remaining in the trust at the end of the trust term pass to the remainder beneficiaries without additional gift tax. A GRAT is a particularly effective tool for transferring assets when interest rates are low.
- **Estate freeze.** Assuming the grantor survives the trust term, a GRAT is an effective estate "freeze" technique. At the grantor's death, the only thing included in the grantor's estate is the value of the annuity payments to the extent they have not been spent or given away.

If the grantor dies during the trust term, however, the trust assets are included in the grantor's estate. Even so, the grantor is no worse off than if the grantor hadn't created the GRAT (other than the cost of creating the trust and the forgone benefit of another planning strategy).

What type of assets can be transferred?

- A GRAT works particularly well with income-producing assets that are appreciating. Property that will increase drastically after transfer to the trust is ideal – for example, stock in a company that may go public. Of course, the grantor must be willing to give up control of the asset.
- Giving fractional interests in assets that generate good cash flow (for example, closely held business stock or rental real estate) is often desirable. The fractional interest might reduce the value of the gift with valuation discounts, and the good cash flow makes it easier for the trust to make the annuity payments.

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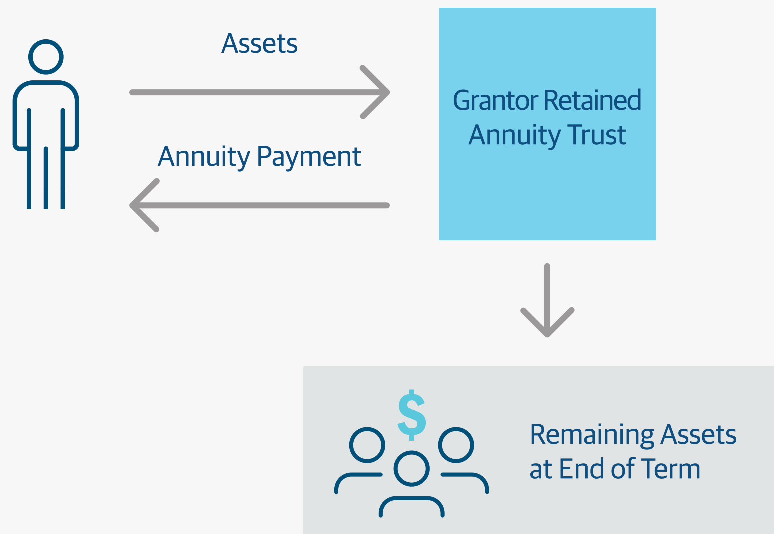
HOW DOES IT WORK?



Mechanics

- The grantor establishes the trust and transfers cash or other assets to it.
- The grantor can serve as trustee during the trust term.
- The trustee pays the grantor an annuity that is a fixed dollar amount each year. This amount can simply be stated in the trust, or it can be expressed as a percentage of the initial value of the trust property. The payment to the grantor may be made from income or principal.
- The grantor cannot make additional gifts to the trust.
- If the grantor dies during the trust term, the remaining annuity payments are typically paid to the grantor's estate.
- At the end of the trust term, the trust assets remaining after the last annuity payment are paid to the remainder beneficiaries. The grantor no longer has any interest in the assets.
- The distribution of trust assets to the remainder beneficiary does not generate any income or transfer taxes.
- The remainder beneficiaries can be individuals or trusts.

TAX CONSIDERATIONS

Gift tax

- The amount of the grantor's gift upon creation of the trust is equal to the fair market value of the assets transferred to the trust less the present value of the annuity payments to the grantor. See Internal Revenue Code (I.R.C.) § 2702.
- The I.R.S.'s method for valuing the grantor's retained annuity payments (and, therefore, the value of the gift to the remainder beneficiaries) considers:
  - the fair market value of the property contributed,
  - the trust term,
  - the amount of the annuity, and
  - the discount rate published by the I.R.S. for the month of the transfer. See I.R.C. § 7520
- Valuation discounts can apply to the transferred property (for example, lack of control for non-voting stock and/or lack of marketability for closely held business stock), which can further leverage the gift.
- The gift does not qualify for the annual exclusion. The grantor must use the grantor's lifetime gift tax exemption or, to the extent that has already been exhausted, pay gift tax.
- "Zeroed-Out" GRAT – this refers to a GRAT that's structured so that there is no gift when the trust is created. This is achieved by having the grantor's retained annuity payments be so large that their present value equals the fair market value of the assets transferred to the trust. This results in no gift tax value being reported by the grantor, but leaves open the possibility that assets will actually pass to the remainder beneficiary at the end of the GRAT's term (if the growth of the assets in the GRAT exceeds the § 7520 rate). See *Walton v. Comm'r,* 115 T.C. 589 (2000), acq. Notice 2003-72, 2003-2 C.B. 964.

Income tax

- A GRAT is typically structured as a grantor trust. That is, the grantor is treated as the owner of the trust for income tax purposes. See I.R.C. §§ 671-679.
- So long as it is a grantor trust, there are desirable results. See Revenue Ruling 85-13, 1985-1 C.B. 184.
  - The grantor does not recognize gain when the assets are transferred to the GRAT, and the grantor is not income taxed on the annuity payments, even if paid with appreciated assets.
  - The grantor includes all items of trust income on the grantor's individual income tax return; the trust pays no income tax.
- The grantor's payment of income tax on the trust's income is not a gift to the trust. See Revenue Ruling 2004-64, 2004-27 I.R.B. 7.
- The remainder beneficiaries take a carryover basis in any property received from the GRAT.

Estate tax

- Because the grantor retains an interest in the trust, the GRAT assets are included in the grantor's estate if the grantor dies during the trust term.
- The amount that is included in the grantor's estate is equal to the portion of the trust assets necessary to produce the grantor's annuity interest. See Treas. Reg. § 20.2036-1(c)(2). It is calculated by dividing the annuity amount by the applicable I.R.C. § 7520 rate (120% of the federal midterm rate) for the month of the grantor's death.
- If the grantor is married, the grantor can provide that amounts included in the grantor's estate from the GRAT are paid to the grantor's surviving spouse (or a marital trust) in a manner that qualifies for the marital deduction. This will defer the estate taxes until the surviving spouse's death.
- If the grantor survives the trust term, the trust assets are not included in the grantor's estate at death.

OTHER CONSIDERATIONS

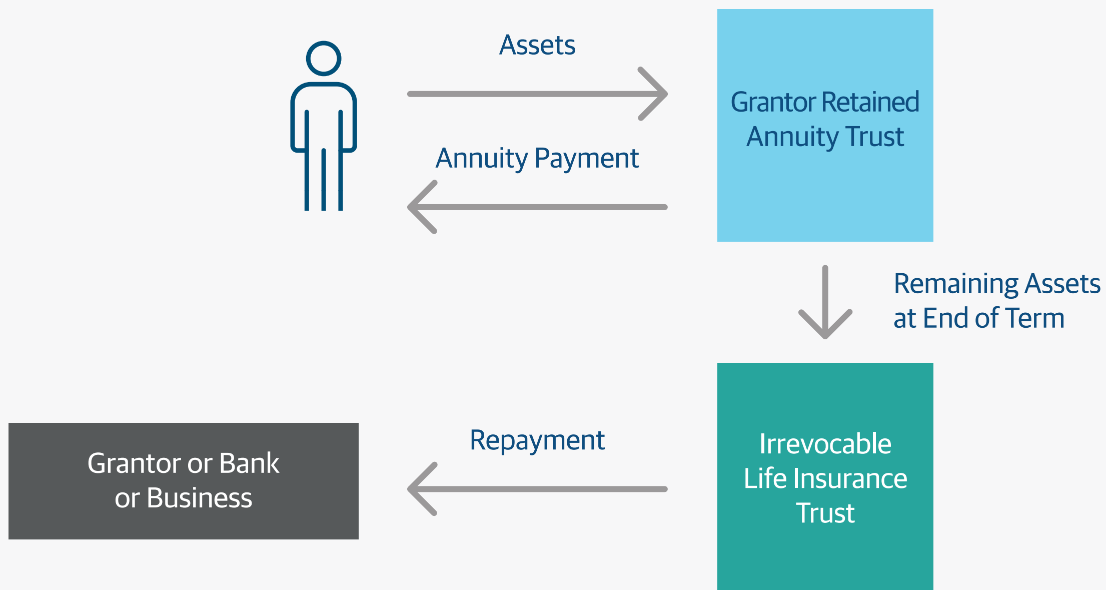
- **Planning considerations.** The keys to success with a GRAT are having the GRAT hold assets that perform better than the I.R.S.'s assumed discount rate and having the grantor outlive the GRAT term. While we can't have absolute certainty, there are some things the grantor can do to minimize the risk that the GRAT won't perform as expected:
  - **Invest assets to beat the discount rate.** If the trust's total return (income and appreciation) exceeds the discount rate, the grantor will transfer more assets to the remainder beneficiary than reported for gift tax purposes upon creation of the trust. Conversely, if the trust's total return is less than the discount rate, it is possible that no assets will pass to the remainder beneficiaries. For example, if the I.R.C. § 7520 discount rate is 2%, the total trust return only needs to exceed 2% to transfer the excess to the beneficiary transfer tax free when the GRAT ends.
  - **Select a term that the grantor will outlive.** To avoid estate inclusion, it is important to select a trust term the grantor is likely to survive.
  - **Purchase life insurance.** The grantor may choose to purchase life insurance to protect against any estate tax liability if the grantor should die during the GRAT term.
  - **Create GRATs with different terms.** The grantor may choose to create GRATs of different terms to balance the risk that the grantor will die during the trust term with the reduced gift tax cost of a trust with a longer term.
  - **Allocation of GST.** A GRAT typically is not used to benefit multiple generations because the generation skipping transfer (GST) tax exemption cannot be allocated until the end of the GRAT term.
- **Comparison with installment sale to a grantor trust.** An installment sale to a grantor trust is another estate planning technique that is designed to freeze the value of property in a grantor's estate. A comparison of the GRAT to an installment sale to a grantor trust is included at the end of this piece.

USING A GRAT AS AN EXIT STRATEGY FOR PREMIUM FINANCING AND SPLIT DOLLAR

A common element of an estate plan is life insurance owned in an irrevocable life insurance trust (ILIT). The policy premium is typically paid with gifts from the client to the ILIT. However, when the premium exceeds the client's available annual exclusions and remaining lifetime gift tax exemption, more sophisticated techniques are used to get cash into the ILIT to pay the premiums.

These techniques include private non-equity split dollar, private loans, third-party loans and installment sales. Each technique involves transferring cash or property to the ILIT and has the common factor of leaving the ILIT with an obligation to repay some amount. A key consideration for these techniques is how to get additional assets to the ILIT with minimal or no additional gifts so that it can repay its loan obligation.

A solution? A GRAT, and ideally, a zeroed-out GRAT. This allows the client to get assets into the ILIT with little or no gift. When the GRAT term ends, the remaining assets pass transfer tax free to the ILIT. The ILIT then has assets to repay its obligation. Here's how it works:



Comparison: GRAT vs. Installment Sale to a Grantor Trust

	GRAT	INSTALLMENT SALE
Taxable gift required?	No	No (but 10% - 20% seed gift recommended)
Appropriate for generation skipping transfers?	No	Yes
Tax risk at death? (estate and/or income tax)	Yes (estate tax inclusion of some or all the trust assets)	Yes (estate inclusion of note; might trigger income tax at death)
Explicit statutory authority for tax treatment?	Yes (see I.R.C. § 2702 and Treasury Regulations)	No (but in line with well-accepted tax principles)
Capital gain recognized on transfer?	No	No
Grantor income taxed on payments from trust?	No	No
Grantor income taxed on trust's income?	Yes	Yes
Distributions to other beneficiaries permitted during trust term?	No	Yes
Ability to correct valuation errors?	Yes	Possibly
Flexibility in structuring annual payments?	Yes (can increase annuity payment up to 20% per year)	Yes (interest only and balloon principal payment is allowed)
Return that the property must generate for technique to "work"	> 120% of federal midterm rate. I.R.C. § 7520.	> 100% of applicable federal (short, mid, or long term) rate

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