HOW TO REDUCE TAXES WITH GRANTOR RETAINED ANNUITY TRUSTS

A Private Clients Group Article

Grantor Retained Annuity Trusts (GRATs) are an important estate planning tool used to reduce estate, gift and similar inheritance taxes by removing assets from an estate. In the right situation, they can allow donors to gift appreciated assets tax-free.

How the GRAT Works

The objective of the GRAT is to transfer wealth to the designated beneficiaries without the imposition of gift or estate tax. A GRAT operates as follows: the Donor transfers high income-producing assets or assets with substantial growth potential (or cash to be invested in such assets) to a trust from which the Donor will receive a fixed amount annually (an “annuity”) for a designated period of years (“GRAT Term”). At the end of the GRAT Term, if the Donor is living, the beneficiaries named in the trust instrument will receive the assets remaining in the GRAT after payment of the final annuity free of gift and estate tax. Depending on the GRAT’s cash flow and/or the appreciation of the GRAT’s assets (the “total investment return”), substantial estate and gift tax savings may be achieved.

Tax Advantages of a GRAT

The tax advantage of this technique is derived principally from the way in which the taxable value of the gift to the GRAT is calculated. The value of the Donor’s taxable gift is not the value of the assets transferred to the GRAT, but rather the current value of the named beneficiaries’ right to receive the assets remaining in the GRAT upon the expiration of the GRAT Term after payment to the Donor of the required annuity payments. Typically, the amount of the annuity and the term of the trust will be calculated so that, according to the Internal Revenue Service's actuarial tables and interest rate, the amount the Donor receives in annuity payments is equal to the value of the initial gift. This form of GRAT is commonly called a “zeroed-out” GRAT.

If the GRAT is zeroed out because the trust’s investment performance is equal to or less than the IRS interest rate, there will be no tax savings, but nothing will be lost except the time and expense of establishing and maintaining the GRAT.

However, if the investment return exceeds the IRS interest rate, then there may be substantial property left in the trust when it ends and that property will pass tax-free to the named beneficiaries.

For example: John Jones transfers $1,000,000 to a GRAT which will pay John an annuity of $63,542.80 per year for 20 years. At the end of 20 years, if John is still living, John’s children will receive the trust funds remaining after payment to John of the last of the 20 annuity payments. Assuming that the IRS 7520 interest rate for the month of the gift is 2.4%, the value of John’s retained annuity payments for gift tax purposes is $999,998.46, and

the value of the taxable gift is $1.54 ($1,000,000 less $999,998.46 = $1.54).

Assume John's GRAT earns an annual investment return of 10% on the $1,000,000. At the end of 20 years, GRAT assets worth more than $3.0 million will be distributed tax-free from the GRAT to John's children. If instead John died owning these assets, the federal estate tax on them would be $1,200,000 (assuming a rate of 40%). A further advantage of the GRAT is that any income generated by, or growth in value of, the $3.0 million between the termination of the GRAT and John's death will also be received by the children free of estate and gift tax.

Terms and Conditions to Be Considered in a GRAT Trust Agreement

GRATs must meet the following requirements:

1. The Donor may be a Trustee.
2. A specified annual annuity payment will be made to the Donor for a term of years. If the Donor dies during the term of years, the annuity payments would continue to be paid to the Donor's estate.
3. The determination of the amount of the annuity payment needed to reduce the taxable gift to a nominal amount involves a fairly complex tax calculation which takes into account the following factors:
    1. The current value of the property
    2. The term of the GRAT
4. The 7520 rate for the month of transfer
5. After the term of the GRAT expires, the trust principal will be distributed to the beneficiaries specified in the trust agreement.
6. Once assets have been gifted to the GRAT, no additional contributions may be made to the GRAT.

Tax Implications of the GRAT

Although there are significant tax advantages to GRATs, it is also important to consider the income tax implications of using a GRAT to remove assets from the donor's estate.

During the term of the GRAT, the Donor will be taxed on all of the income and capital gains earned by the trust, without regard to the amount of the annuity paid to the Donor.

At the end of the GRAT term, the beneficiaries' tax basis in the trust property will be equal to the Donor's tax basis at the time the assets were transferred to the GRAT. If the property was in the Donor's estate, the beneficiaries would receive a "step?up" in the property's tax basis to the fair market value of the property at the Donor's death. Therefore, if appreciated property is gifted to the GRAT and the beneficiaries sell the property after the GRAT terminates, they may be subject to higher capital gains tax then if they had received it in a Will.

If the Donor dies before the GRAT annuity payments cease, the trust assets will be taxable in the Donor's estate. Consequently, it is important to consider the Donor's life expectancy in selecting the GRAT Term. Also, if the Donor is married, careful consideration should be given as to whether and how to qualify the GRAT for the estate tax marital deduction if the Donor does not survive the GRAT term in order to avoid paying estate tax at the death of the Donor that could otherwise be postponed until the surviving spouse's death.

If you are considering a GRAT as part of your estate plan, contact a Cummings & Lockwood trusts and estates attorney who can assist you.

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