CUMMINGS & LOCKWOOD LLC

# GRANTOR RETAINED ANNUITY TRUSTS

A Private Clients Group White Paper

Grantor Retained Annuity Trusts are one estate planning tool used to reduce inheritance taxes by removing assets from an estate. A Grantor Retained Annuity Trust, often referred to as 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.

## How the GRAT Works

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 duration of the GRAT and the amount of the annuity payments are fixed to reduce the taxable gift to zero or a nominal amount. This form of GRAT is commonly called a “zeroed-out” GRAT.

For many years, the IRS attempted to discourage the use of GRATs by using a method for calculating the taxable gift at zero or a nominal amount. Members of the Walton family challenged the IRS position in court and won a major victory for taxpayers. In response to their defeat in the Walton case, the IRS released a Notice on October 15, 2003 changing its position and accepting the validity of a zeroed-out GRAT.

If the total investment return of a GRAT exceeds the anticipated return based on the rate prescribed by the IRS for the month the GRAT is established (the “7520 rate”), this “excess” investment return will pass gift and estate tax-free to the Donor’s beneficiaries upon the expiration of the GRAT. If the total investment return is less than the 7520 rate, no assets will remain to be transferred to the Donor’s beneficiaries upon the expiration of the GRAT. Nevertheless, as long as the taxable gift upon funding the GRAT is zero, nothing will be lost other than the expense of establishing and administering the GRAT.

## Example I ("Long-term GRAT")

John Jones transfers $1,000,000 to a GRAT which will pay John an annuity of $76,211 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 20 annuity payments. Assuming that the IRS 7520 interest rate for the month of the gift is 4.4%, the value of John’s retained annuity payments for gift tax purposes is $999,998.95, and the value of the taxable gift is $1.05 ($1,000,000 less $999,998.95 = $1.05).

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 $2.3 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 $920,000 (assuming a rate of 40%). A further advantage of the GRAT is that any income generated by, or growth in value of, the $2.3 million between the termination of the GRAT and John's death will also be received by the children free of estate and gift tax.

## Example II ("Short-term GRAT")

Jane Jones transfers $1,000,000 worth of stock to a 2-year GRAT. Jane is convinced that the stock is undervalued and expects it to increase by 25% per year for the next two years. Assuming an IRS 7520 interest rate of 4.4%, Jane must receive an annual annuity of $533,248 for the two years of the GRAT to reduce the taxable gift to a nominal amount. If the stock appreciates in value at the 25% annual rate that Jane expects, $362,693 of stock will pass tax-free to her children at the end of the two year term.

## Terms and Conditions to be Considered ina GRAT Trust Agreement

- The Donor may be a Trustee.
- 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.
- 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; and

(3) the 7520 rate for the month of transfer.

- After the term of the GRAT expires, the trust principal will be distributed to the beneficiaries specified in the trust agreement.
- Once assets have been gifted to the GRAT, no additional contributions may be made to the GRAT.

## Tax Implications of the GRAT

The objective of the GRAT is to transfer wealth to the designated beneficiaries without the imposition of gift or estate tax. It is similar to an outright gift in that it avoids estate and gift tax on the future income and appreciation on the gifted property. Unlike an outright gift that uses up lifetime gift tax exemption equal to the value of the gifted property on the date of the gift, a "zeroed out GRAT" will use up only a nominal amount of gift tax exemption. Also, unlike an outright gift, a GRAT gift will result in either a "win" or a "tie", but never a "loss". An outright gift on the other hand can have a negative result if the property declines in value after the gift is made.

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 GRAT is treated as a grantor trust for income tax purposes. Consequently, 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. Therefore, if appreciated property is gifted to the GRAT and the beneficiaries sell the property after the GRAT terminates, any capital gains tax on the difference between the sales price and the Donor's tax basis will reduce the net value of the property transferred. If the property instead were included in the Donor's estate at death, 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. However, under current tax law the federal capital gains tax rate continues to be significantly less than the federal estate tax rate (up to 40%) which otherwise would have been due had the property transferred to the beneficiaries by the GRAT been retained until death. In addition, if after the termination of a GRAT, the appreciated property is sold while it continues to be held in a trust that is treated as a grantor trust for income purposes, the grantor will pay the capital gains tax.

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.

## Frequently Asked Questions About the GRAT

Here are a few practical questions that arise from time to time in our conversations with clients who are exploring the possibility of creating a GRAT:

**Q: Can you give me an example of the GRAT tax calculations?**

**A:** Table I includes a few examples of GRAT terms and annuity payments which minimize the taxable gift, assuming an IRS interest rate of 4.4% at the time the trust is established.

**Q: What if the GRAT's investment performance is equal to or less than the IRS interest rate?**

**A:** If the GRAT's annual compounded investment return equals the IRS interest rate, then the Grantor's annuity interest will be fully paid, but there will be only a small remainder in the GRAT to pass on to the Donor's children. If the GRAT's annual compounded investment return is less than the IRS interest rate, then the trust principal will be exhausted before the end of the GRAT term. There will be no tax savings, but nothing will be lost except the time and expense of establishing and maintaining the GRAT.

**Q: If there is insufficient income to pay the annuity in one year, can the deficiency be paid in another year, rather than using principal?**

**A:** No. The IRS regulations provide that an annuity interest is only valid if it is paid no later than the due date for the trust tax return to which it relates. Therefore, deficiencies must be made up from principal. Under current law, trust assets can be distributed in kind to pay the annuity without causing capital gains taxes to be paid on the distributed property.

IRS regulations also prohibit the Donor from loaning the GRAT funds with which to make the annuity payment.

**Q: If the grantor lives in a state that imposes a state gift tax or if the property to be placed in the GRAT is real property located in such a state, are there any additional tax considerations?**

**A:** Yes. If the GRAT is not "zeroed-out", a state gift tax may be due. This should be considered when designing the GRAT.

**Q: Can an interest in a closely held business be transferred to a GRAT?**

**A:** Yes. The GRAT can be an effective method of "freezing" the value of the business. It can also minimize any risk from a valuation of the business interest transferred to the GRAT that is challenged by the IRS. For example, if a 55 year-old business owner's interest in his business is valued at the amount of the owner's remaining gift tax exemption (assume $5,000,000), the business owner may be able to make an outright gift of the interest to his children and avoid gift tax by using his lifetime exemption. But if the value of the interest is doubled ($10,000,000) upon audit of the business owner's gift tax return, gift tax will be due equal to the gift tax rate multiplied by the amount of the gift tax exemption ($2,000,000). If the interest is instead transferred to a "zeroed-out" GRAT to pay him for 20 years an annuity equal to 7.6211% of the initial value of the property contributed to the trust ($76,211), then assuming an IRS interest rate of 4.4%, the value of the taxable gift will be $1.05. If the value of the business interest is increased upon audit by the IRS, the annuity payments required to be paid to the Donor would increase, but there would be no appreciable increase to the taxable gift.

**Q: What are the costs of managing a GRAT?**

**A:** The costs of the GRAT include attorneys' fees for preparing the trust agreement and the gift tax return, and some cost if professional assistance is required in making certain the annuity payments are made correctly.

### Table I

**Example of $1,000,000 GRAT established when IRS interest rate is 4.4%, assuming total annual investment return of 10%.**

| Term of GRAT (in years) | Annual Annuity Payment Made to Donor (Assuming 4.4% IRS Rate) | "Tax Free" Gift to Beneficiaries at End of Term (Assuming 10% Total Return) |
|---|---|---|
| 2 | $533,248 | $90,180 |
| 3 | $363,082 | $129,200 |
| 5 | $227,159 | $223,682 |
| 10 | $125,758 | $589,490 |
| 15 | $92,474 | $1,239,107 |
| 20 | $76,211 | $2,362,498 |

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This document is intended to convey to you the principal characteristics of Grantor Retained Annuity Trusts as they apply to common situations.  For this reason we have deliberately simplified technical aspects of the law in the interest of clear communication.  Assumed investment returns have been selected for illustrative purposes only and are not intended to represent any actual investment.  Actual investment returns may vary and are not guaranteed.  Under no circumstances should you or your other advisors rely solely on the contents of this document for technical advice nor should you reach any decisions with respect to this topic without further discussion and consultation with a Cummings & Lockwood attorney.

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