Grantor Retained Annuity Trusts

Executive Overview

Transferring wealth can be a significant challenge for individuals and families who have achieved success and want to pass assets to family members in the most tax-efficient way. Grantor retained annuity trusts (GRATs) may offer a way to effectively transfer assets that are believed to likely appreciate in value, and earn more than the Internal Revenue Service’s assumed interest rate during the GRAT term in an effort to pass the appreciation to beneficiaries with minimal to no gift tax. If a GRAT is funded with assets likely to appreciate in value, it is possible that the appreciation of the assets may be higher than the assumed IRS interest rate. Thus at the end of the term, there may be value remaining in the GRAT even though the initial IRS calculation suggests that it should have been zero. This remaining value may be passed on to the beneficiary without incurring a gift tax.

A GRAT is an irrevocable trust – once the trust is put in place, it cannot be reversed. The grantor transfers assets to the trust and receives annuity payments based on the value of the asset plus an assumed interest rate determined by the Internal Revenue Service over the term of the trust. Once the trust expires, the grantor retains no further interest in the remaining value of the asset and it is distributed to beneficiaries of the trust as a gift. Named beneficiaries can include individuals or another trust for the benefit of individuals.

This strategy may work effectively with assets that are likely to appreciate in value over the term of the trust. A GRAT may allow a person to share the future appreciation of an asset with the next generation with no gift tax.

GRATs can work effectively for individuals who understand they are giving up control of their assets by transferring the assets into an irrevocable trust and that they will need to survive the term of the trust to realize the tax benefits.

Creation of a GRAT should be discussed with your tax professional (CPA) and attorney to determine if this strategy will work as a component of a comprehensive financial plan.

Important disclosures provided on page 5.
Transferring Wealth in a Tax-Efficient Manner

Preserving and transferring wealth creates a unique challenge for many individuals and families. Many clients want to share their wealth with children and grandchildren, but doing so may mean the loss of a significant portion of their assets to transfer taxes, including gift and/or estate taxes.

The question is how to transfer the full benefit of an intended gift to beneficiaries. Creative solutions exist that may help preserve the current and future potential appreciation of an asset for non-charitable beneficiaries in ways that may make it possible to minimize and/or avoid gift and estate taxes.

A Grantor Retained Annuity Trust (GRAT) is an estate planning strategy that may be particularly effective with assets that are likely to appreciate in value or that generate an income stream, such as:

- real estate
- stocks
- bonds
- businesses

The basic premise of a GRAT is that the grantor establishes an irrevocable trust lasting a pre-defined period of years. The grantor gives up ownership and control over the assets used to fund the trust but during the term of the trust, receives annuity payments on at least an annual basis. When the term of the trust expires, the grantor no longer retains any interest in the trust assets or income. Instead, the remaining trust assets are passed on to named beneficiaries. Named beneficiaries can include individuals or another trust for the benefit of individuals.

The GRAT is a “Grantor Trust” for tax purposes – which means that transactions between the grantor and the trust do not have tax implications, and that activity occurring within the GRAT (dividends, interest, etc.) is attributed to the grantor. This may have the effect of transferring more assets to the beneficiaries.

Transfer taxes may potentially be avoided because of the annuity payment to the grantor. Normally, the value of the asset, if passed on to a beneficiary, would be subject to tax. However, since the grantor will receive an annuity payment from the trust for a period of years, it is assumed to offset the value of the gift, therefore minimizing gift tax liability. The trust should be structured so that the retained annuity value (the total payments the trust will pay to the grantor) is as close as possible to the value of the property transferred plus a rate of interest as determined by the IRS (currently 2.6% for August, 2010).

The actuarial value of the stream of payments is determined by several factors as dictated by IRS rules:

- the length of the trust term
- the dollar amount of the annuity payable
- the age of the grantor at the time the trust is created
- the applicable IRS interest rate in the month the trust is created

While the grantor receives payments based on an assumed interest rate determined by the IRS, the actual return earned by the underlying assets in the trust may be greater. The most effective use of a GRAT would be to use an asset that increases in value at a faster rate than the level of annual payouts to the grantor. The increased value would then be passed on to beneficiaries without any further gift or estate tax implications. This is one reason why a GRAT has the potential to be such an effective transfer vehicle to family members of the donor. Beneficiaries may receive an asset with potentially greater value sheltered from gift or estate taxes. Those considering establishing a GRAT should assess the appreciation potential of the assets that would be included in the trust.
Determining an appropriate term

The term of a GRAT can be set for time spans as short as two years. However, Congress has been considering legislation that would require that the term of a GRAT be a minimum of 10 years.

The grantor will receive annuity payments spread out over the term of the trust equal to the initial value of the gift plus an assumed rate of interest. If the term is shorter, annual payments to the grantor will be larger. If the term is longer, it may be possible to achieve greater appreciation to pass on to beneficiaries.

Another key determinant in structuring the term of the trust is life expectancy of the grantor. If the grantor of the trust dies during the term of the trust, the trust’s value will be included in the decedent’s estate – which would be the same result as if the GRAT hadn’t been created.

Therefore, it may make sense to establish a term for the trust that the grantor can reasonably expect to survive. This may allow for the complete transfer of the trust and the maximization of tax advantages.

The primary attraction of a GRAT is the estate tax savings generated if it is properly executed. It can be a powerful strategy to begin shifting wealth to future generations in a way that may allow children, grandchildren and others to benefit from continued potential appreciation of the asset without the impact of gift or estate tax consequences, if the trust is properly managed and the grantor survives the term of the trust. If the GRAT is executed correctly and consistent with IRS rules, resulting gift taxes may be minimized, helping to preserve the $1 million lifetime gift tax exemption for other transfers.

In summary, GRATs can be one of many effective estate planning tools to consider in an effort to preserve and transition wealth to future generations. In collaboration with a client’s other advisors, The Private Client Reserve can help assess how this approach may work in conjunction with a comprehensive financial plan.

How a GRAT works – Example #1

Bob owns a business valued at $5 million that has been growing at an average rate of 10% per year. Ultimately, he wants to pass the business on to his children, but is concerned that gift or estate taxes will take a significant bite out of the value of the business before the children would attain control.

By planning ahead, Bob is able to place the business in a GRAT with a 15-year term. The IRS values the transfer at the business’ fair market value minus the value of the retained annuity stream that Bob will receive over the 15-year term. Therefore the gift is discounted according to the IRS published interest rate at the time of the transfer. This means the gift tax could be reduced to zero if the current value of the asset is equal to the value of the annuity payments Bob will receive.

Assuming Bob survives the 15-year term, the appreciation of the business will transfer successfully to his children with little or no tax impact. Bob benefited from ongoing annuity payments throughout the 15-year period, which had the same effect as selling the business on an installment basis, as he received payments totaling the initial $5 million value plus interest. Assuming the business continues to grow in value at a rate of 10% per year, the remaining value of the business ($5 million plus actual appreciation minus the annuity payments made to Bob) could result in a gift that exceeds the initial value of the business when Bob placed it in trust. Yet assuming Bob survived the term of the GRAT and received annuity payments as required, the entire gift would be free of gift or estate taxes. By contrast, had Bob chosen to leave the business to his children as part of his estate, taxes would have had a significant impact on the net value to the family.
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**How a GRAT works – Example #2**

Marie is an executive at a large company and owns company stock valued at $1.5 million. The stock has lost value from its peak several years earlier, but the company remains well positioned for steady growth in the years to come. Even with the recent decline, Marie would face significant tax consequences if she liquidated the stock, because of the low cost basis associated with her ownership position.

Marie establishes a GRAT for the company stock, naming her daughter as beneficiary, with a 10-year term. Marie will receive annuity payments each year, with the total value of the payments matching the initial value of the stock of $1.5 million plus an assumed interest rate.

Marie is taking advantage of the fact that the stock appears to be undervalued (after a market correction) and she anticipates that over the next decade, it could enjoy solid growth. If, during that ten-year timeframe, the stock doubles in value, her daughter would receive a gift equal to the stock’s appreciation in excess of the annuity payment without gift or estate tax. This reduces Marie’s estate, helping to minimize future estate tax consequences, while Marie still received payments in excess of the value of the stock at the time the trust was established.

**Issues to consider before establishing a GRAT**

A GRAT can be an effective, long-term tax management strategy. However, each individual should consider, in consultation with their tax and legal advisors, their own circumstances and how the decision to establish a GRAT could affect their financial situation.

Among the concerns to keep in mind are:

- A GRAT is a form of an irrevocable trust. That means control of the asset is no longer retained by the grantor, but instead is transferred to the trust. Throughout the term of the trust, an asset of value is no longer in control of the grantor. The trustee of the GRAT will be responsible for liquidation and re-investment of assets that are concentrated.

- If the grantor does not survive the term of the GRAT, the tax benefit will be lost. The transfer of assets can still occur, but gift or estate taxes may apply.

- If the investment value of the asset should decline during the term of the trust, the strategy may not prove to be beneficial from a tax perspective. The resulting gift to beneficiaries would be smaller in this instance, and the tax benefit lost.

- Tax laws are subject to change, and this could affect the flexibility individuals have in structuring the terms of the trust.

While trusts can be exceptional planning tools and provide a valuable way to transfer wealth to loved ones, there are many variables to consider.
Considering GRATs as part of an overall financial strategy

A Wealth Management Advisor can work with you and your tax and legal advisor to help determine if GRATs are an appropriate strategy for your specific financial needs. It is one of many tools that successful families may want to consider as they review and select a comprehensive slate of solutions to potentially transfer wealth in a cost-effective way to future generations.

In discussing options, a tax professional (CPA) and attorney should be included in the conversation. GRATs may be an effective tool to limit the tax impact of a wealth transfer to family members and others. A detailed discussion with appropriate professionals will help determine whether a GRAT is the right fit for your specific circumstances.

“If the GRAT is executed correctly and consistent with IRS rules, resulting gift taxes may be minimized, helping to preserve the $1 million lifetime gift tax exemption for other transfers.”