HERITAGE STRATEGIES LLC

ADVANCED MARKETS INSIGHT

M Financial Group's Advanced Markets Insights are designed to help clients understand sophisticated planning strategies and their applications.

M Financial Group continues to lead the industry in insurance due care and client advocacy, providing valuable insight and analysis that delivers significant value to clients.

Grantor Retained Annuity Trusts (GRATs)

What is a Grantor Retained Annuity Trust (GRAT)?

In a grantor retained annuity trust (GRAT), a grantor transfers assets into an irrevocable trust and receives a stream of payments for a fixed term of years. At the conclusion of the GRAT term, any property that remains in the trust is transferred to the trust's named beneficiaries.

The amount of the annual payment and the term of the GRAT are both determined at the time the GRAT is established. The higher the annual payment and the longer the term of the trust, the lower the remainder of assets in the trust at the end of the term. It is not uncommon to set up multiple GRATs with varying terms.

Discounts

GRATs are typically funded with a gift of assets that are expected to appreciate in value, such as common stock. Often times, multiple GRATs are used, each funded with a different asset. Done properly, the GRAT technique can be used to "freeze" the value of the assets for estate and gift tax purposes (see Other Tax Considerations).

Certain assets, such as closely held stock or units in a Family Limited Partnership (FLP) may also be eligible for a discount for gift tax valuation purposes when transferred to a GRAT. An experienced accountant can help determine the degree to which a specific asset qualifies for a discount.

Gift Tax Implications

The initial transfer of assets to the GRAT is considered a "future interest" gift that is subject to gift tax and cannot qualify for the gift tax annual exclusion. However, the grantor may use a portion of his or her lifetime gift tax exemption to shelter some or all of the gift from gift taxes.

Value of the Gift

The value of the gift is the expected remainder interest of the GRAT. The GRAT remainder interest is the difference between the value of the property transferred to the GRAT and the present value of the stream of payments to the grantor, discounted by the interest rate in effect as provided under Internal Revenue Code Section 7520[1].

Zeroed Out GRAT

A "zeroed out" GRAT (also known as a Walton GRAT) is a trust in which the present value of the retained annuity equals the value of the property transferred to the GRAT, causing the gift to the GRAT to be valued at zero. Using a zeroed out GRAT can be particularly valuable for individuals who do not have or do not want to use their lifetime gift tax exemption.

1 The Section 7520 rate is equal to 120% of the mid-term Applicable Federal Rate (AFR), published monthly by the IRS.

M Financial Group™
Member Firm

Other Tax Considerations

- If appreciated property is transferred to a GRAT, the tax on any gain will eventually be paid by the grantor, the trust, or the trust beneficiaries. No step-up in basis will be allowed, and the basis of a remainder person would generally be the same as the grantor's. However, the donee's basis may be increased by gift tax attributable to the gift in the proportion that the net appreciation (fair market value of gift – basis) bears to the value of the gift.
- If the grantor dies during the term of the trust, some or all of the property inside the GRAT will be included in the grantor's taxable estate.[2] This results in the loss of the full transfer tax benefit of using the GRAT. However, if death occurs prior to the end of the term, the grantor is arguably in no worse position for having used this technique. Had the appreciating asset been left in the estate, and not placed in a GRAT, the tax consequence would have been the same or possibly even greater.
- If the grantor lives beyond the specified term, 100 percent of post-gift appreciation in the property's value escapes estate and gift tax, since the gift was complete upon the funding of the trust.
- A GRAT is a grantor trust[3]; therefore, the grantor is treated as owner of the trust during its term, and is taxed on the income from the trust as it is earned.

Advantages

- Because the value of the transferor's gift for gift tax purposes is determined at the time of the transfer, if trust property grows at a rate in excess of the growth rate assumed under section 7520, the excess appreciation generally will pass to the remainder beneficiaries without further gift tax consequences to the grantor.
- The federal estate tax doesn't apply to a property interest unless the decedent owned it at death or held a property right strong enough to cause it to be pulled back into his estate. In a GRAT, once the grantor lives longer than the specified term, he neither owns the property nor any rights to it. The property therefore avoids estate taxation.

Considerations

- The stream of annual payments from the GRAT to the grantor must meet the requirements of a "qualified interest" under Section 2702.[4] Note that the payments need not be level, and may start out low and increase by up to 20 percent a year, thus enhancing the appreciation potential of the trust's assets.[5]
- A GRAT must last for a specified term of years – not the lifetime of the grantor.
- The annual payment to the grantor must occur every year. If trust income is insufficient, the trustee must be required to invade the trust principal to make the payment. A note may not be used, directly or indirectly.
- The GRAT is an irrevocable trust, so once assets are placed into the trust the grantor is precluded from taking other planning measures.
- It may be appropriate for the remainder beneficiary of a GRAT to purchase insurance on the life of the grantor and carry that life insurance during the period of time in which the death of the grantor would cause estate tax inclusion. The insurance proceeds, received estate tax free, could then be used to purchase assets from the grantor's estate and thereby provide the estate with the liquidity to pay the estate tax.
- If a husband and wife in a community property state transfer community property to a GRAT, and either dies during the term, the value of his or her community interest in the trust would be included in his or her taxable estate, either in whole or in part. This may be solved by creating separate GRATs for each spouse.
- Attorney fees and the other transaction costs, such as appraisal fees and property titling costs may be incurred to establish the trust.

2 IRC Section 2036

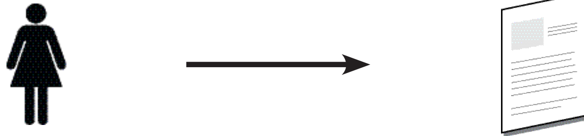
3 A Grantor Trust is one that triggers the Grantor Trust Rules (IRC Sections 671-678)

4 Internal Revenue Code Section 2702(b) defines a "Qualified interest" as: (1) any interest which consists of the right to receive fixed amounts payable not less frequently than annually, (2) any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and (3) any noncontingent remainder if all of the other interests in the trust consist of interests described in paragraph (1) or (2) .

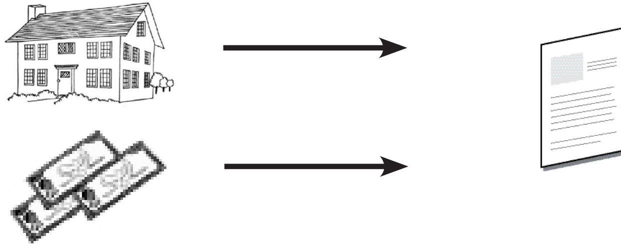
5 IRC Section 25.2702-3(b)(1)(ii)(A)

Grantor Retained Annuity Trust

1. A grantor establishes a grantor retained annuity trust with the assistance of an attorney.

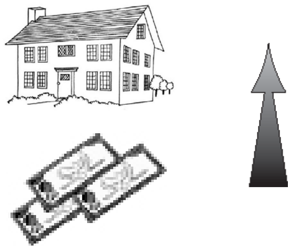


2. The grantor funds the trust with a gift of assets that are expected to appreciate significantly, such as stock or real estate. Depending on how the GRAT is structured, the transfer may or may not incur gift tax.



3. The grantor receives annual payments from the trust for a specified number of years.

4. The assets appreciate throughout the term of the GRAT.



5. If the grantor survives the term of the GRAT, the appreciated assets pass to the GRAT remainder beneficiaries with no additional gift tax or estate tax due.

For More Information

To learn more,
please contact:

HERITAGE STRATEGIES LLC
135 Crossways Park Drive
Suite 402
Woodbury, NY 11797

212.485.1536
212.485.1537 Fax

www.HeritageSLLC.com

Circular 230 Compliance: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this bulletin is not intended or written to be used, and cannot be used, for the purpose of (a) avoiding penalties under the Internal Revenue Code, or (b) promoting, marketing, or recommending to another party any transaction or matter addressed herein. All programs and techniques presented are subject to applicable federal and state laws.

This material is not intended to provide tax, legal, or accounting advice. This information should not be used by any taxpayer for the purpose of avoiding or circumventing IRS rules and regulations. Clients should seek the advice of their professional advisors.