TOPIC: Grantor Retained Annuity Trusts

Individuals or couples who hold what are determined to be excess assets (those they will never need to rely upon for income or meeting financial needs during their lifetimes), and who wish to pass along these assets to the next generation or other family members at reduced or even zero gift taxes, may wish to consider establishing a Grantor Retained Annuity Trust (GRAT). A GRAT is just one of many possible solutions for those who wish to gift away assets in amounts larger than the annual gift exclusion amount ($14,000 per person in 2015) or without using or exceeding their lifetime unified credit amount ($5,430,000 in 2015).

In its most basic form, a grantor or donor transfers property into an irrevocable trust (the GRAT), which in turn provides the donor an annuity for a certain term (usually, a specified number of years). At the end of the term, the remainder beneficiaries (for example, the donor's children) get whatever is left in the trust after the last annuity payment is made.

To determine the value of this "gift," or remaining assets in the trust, the discount rate under I.R.S. Section 7520 is used. In short, the gift's value will be equal to the value of the donated assets less the present value of all of the annuity payments to be paid out. The value of any gift and amount of gift taxes owed are determined up front, and are paid by the donor. However, many attorneys and tax advisors will help clients set up a GRAT so that under current law the value of the gift equals $0 (often referred to as "a zeroed-out GRAT"), and therefore no gift taxes will be due. An example may help explain this more fully.

Suppose the Section 7520 interest rate is 2.2%. If an individual places $1,000,000 into a GRAT for 10 years, if the assets earn 2.2% per year, and if the trust pays an annuity at the end of each of the ten years back to the donor of approximately $112,495, then the amount remaining in the trust after the last annuity payment is made will be $0. The value of the gift as determined by the I.R.S. up front is also equal to $0. Why? Should the assets earn exactly 2.2% per year, the remainder beneficiaries would get nothing.

However, if the assets earned more than 2.2% per year, then there would be assets leftover that would pass along to the remainder beneficiaries without being subject to gift taxes. For instance, in the above example, if the account earned 5% per year instead of 2.2%, there would be approximately $213,949 of remaining assets the

beneficiaries would receive. Therein lies the potential attractiveness of GRATs: if assets in the trust earn a higher rate of return than the Section 7520 rate, there will be value to pass along that may avoid some or all gift taxes. When the Section 7520 rate is low, the attractiveness of GRATs is strong (i.e., the probability of earning a better rate of return is higher than normal).

The risk, of course, is that the assets earn less than or an amount just equal to the Section 7520 rate. In these cases, the annuity payments will fully exhaust the assets in the trust and no assets will have passed outside of the donor's estate. The donor will have lost the legal, tax and investment costs of setting up and managing the GRAT. The upside, however, is unlimited as there is no limit to how much the assets may grow each year. A second risk is that the grantor dies before the GRAT term is completed. If the grantor dies before the trust expires, all assets still in the GRAT revert back to the estate of the deceased and may be subject to estate taxes.

GRATs may also help those individuals who worry about being subject to estate taxes, and who wish to begin transferring assets to the next generation now. By donating higher-growth assets to a GRAT, the donor provides a higher probability that the Section 7520 rate will be exceeded, and excess assets passed along. In addition, future growth, once assets have passed to the beneficiaries, will occur outside of the donor's estate.

In summary, by use of a GRAT, donors may be able to pass assets to family members in amounts greater than the annual gift exclusion with a pre-determined amount of - or even no - gift taxes due, and may even begin to address estate tax issues by reducing their overall estate.

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