GRANTOR RETAINED ANNUITY TRUSTS

A Grantor Retained Annuity Trust (GRAT) allows a donor to transfer property to a trust, retaining for a period of time the right to receive an income stream (an annuity) from the property. The benefit of this technique is that, although the entire property goes to the donor's beneficiaries (usually the children) at the end of the term, the gift tax on the transfer is computed on the remainder interest at the time of the gift, after subtracting the value of the income stream retained by the donor. This can permit a transfer of property at a fraction of its actual value. The higher the income stream, the greater the discount on the remainder interest passing to the children.

This technique is particularly effective where the income from the property outperforms the assumed return, which is based on an interest rate (called the Section 7520 rate) published by the federal government on a monthly basis, or the property grows in value during the term.

The annuity amount is based on a fixed dollar amount or percentage of the property value at the time of the creation of the trust, and remains level during the entire term of the trust. Regardless of the amount actually received by the grantor, the grantor is taxed on all the income from the property while the trust remains in existence.

How It Works

Let's assume that Tom Taxpayer owns a duplex worth $300,000 in an area that is experiencing a renewal, and that it generates $18,000 a year in net income. Tom puts the property into a GRAT for a 15 year term, retaining a payment of 5% of the value of the property, or $15,000 per year. The Section 7520 rate (also known as an Applicable Federal Rate, or AFR) is 4.6%. Tom anticipates the property will grow at 3% per year in the future. The result of this is shown in Figure 1.

Grantor Retained Annuity Trust For
Tom Taxpayer

Transfer Date 11/21/2002	AFR 4.60%
Based on Shorter of Life or Term (15 yrs)	Discount Pct .00%

Property Value	$300,000
Times Payment Percentage	.05000
Equals Annual Payment	$15,000
Times Annuity Factor	9.2137
Equals Value of Return to Donor	$138,206
Remainder (Gift)	161,794
Remainder (Gift) per IRS	161,794
Gift Tax	$0
Value of Property at Death in 2022	
(without transfer)	$837,551
Retained Pmts + Gift of Remainder	274,786
Property Transferred Tax Free	562,765
Times marginal estate tax rate	55%
Projected Estate Tax Savings	$309,521

Figure 1

Tom's gift to his children (who will receive the property after the 15-year term) is a little over half the fair market value of the property. The "annuity factor" which is used to determine the value of the

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interest Tom is retaining is based on his age at the time of the transfer (assumed to be age 63). The value of his gift is the value of the property, less the value of Tom's retained interest. There is no gift tax to pay since the value of the gift is well within Tom's Applicable Exclusion Amount for gift tax purposes ($1,000,000).

The bottom portion of Figure 1 shows an estimate of what the property might be worth at Tom's death (assumed to be in 2022), and the potential savings as compared to having this property (at its increased value) taxed in Tom's estate.

Tom will receive $15,000 from the trust each year for the 15-year period. Since the net income is $18,000, this will more than cover the annuity payment and the excess income will build up in the trust and eventually pass to the children when the trust terminates. However, since Tom has to pay income tax on the full $18,000 earned by the trust, he may be a little out-of-pocket. The silver lining is that, by paying this tax, he is actually making a tax-free gift to his children by allowing their remainder interest to increase in value, and he is also minimizing any build-up of funds in his own estate.

At the end of the trust term, Tom's annuity will stop. However, if the property value grows as predicted, he will have shifted$837,000 out of his estate for transfer tax purposes, at a transfer tax "cost" of only $162,000.

If Tom were to die within the 15-year term, the entire value of the trust assets would be brought back into his estate. In that case, although he wouldn't realize the estate tax benefits of the GRAT, he is generally no worse off than if he had not made the gift, except for the legal fees incurred to establish the GRAT. In the right circumstances, that can be a very small risk in view of the potential benefits.

A GRAT can be created for any length of time. In some cases, where the gifted property is expected increase in value in the near future (such as a corporation that may go public), a GRAT can be for a term of two to three years. Although the high annual payments to the Grantor in such a case may result in some of the property being returned to the Grantor, if the assets perform as expected, most of the appreciation will transfer to the children at the end of the term.

Nuts and Bolts

The Grantor can act as the Trustee of the trust if desired, so no third parties need be involved.

The remainder interest can pass to a trust for the Grantor's children if the Grantor wishes to provide some protection and/or investment guidance for them after the GRAT has terminated. It can even pass to a generation skipping trust which is not taxable at the children's deaths, although no generation skipping exemption can be applied until the trust terminates and it would have to be applied at the then current value of the trust.

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The annuity interest retained by the Grantor must be a “qualifying interest” for federal tax purposes in order to be subtracted from the entire interest of the property in measuring the gift. A qualifying interest must meet the following requirements

- The annuity must be paid during the year or in the subsequent period prior to the regular date required for filing a trust tax return;
- The "fixed amount" paid to the Grantor may be a stated dollar amount or fixed percentage of the initial value of the trust property;
- The trust must set the length of the term of the payments, which must be within the actuarially determined lifetime of the Grantor;
- The trust must prohibit commutation of the retained interest (no subsequent shortening or giving up of a retained interest);
- In general, the trust must prohibit the payment of any amount to anyone other than the transferor; and
- The payment right must be cumulative (that is, if a payment is missed, it must be made up, with interest).

Conclusion

In the right situation, a GRAT can be a tremendously effective tool to “leverage” an individual’s Applicable Credit Amount, by transferring future appreciation in value of an asset to the Grantor’s beneficiaries tax-free.

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