

The Grantor Retained Annuity Trust

A Grantor Retained Annuity Trust (GRAT) is a powerful estate planning tool which can be used to transfer wealth to the next generation virtually free of gift and estate tax. A donor contributes assets expected to appreciate rapidly to a GRAT in exchange for a stream of annuity payments for a term of years. The annuity amount is determined by the statutory rate fixed by the Internal Revenue Service. Because the value of the assets initially contributed to the GRAT, plus the small amount of statutory interest on those assets, are returned to the donor through the annual annuity payments over the term of the GRAT, the gift to the remainder beneficiaries is virtually zero. At the end of the GRAT term, if the trust assets have appreciated at a rate higher than the statutory rate, any excess appreciation will be transferred to the remainder beneficiaries free of gift or estate tax.

While GRATs may not significantly reduce the overall size of a donor's estate, the benefit of passing future appreciation to the next generation with little or no gift or estate tax consequence cannot be overstated. GRATs are particularly effective when statutory interest rates are low and the rate of appreciation on the contributed assets is likely to exceed those rates.

Key Advantages of GRATs:

Flexibility:

Once a GRAT has been funded, assets inside the GRAT may be exchanged for assets outside the GRAT. If the assets don't perform as the grantor expected, they can be removed from the trust and replaced with assets with a greater potential for appreciation. This could help a grantor navigate risks such as creating a GRAT when the stock market is trading near historic highs, which could increase the likelihood of a potential decline in stock prices during the term of the GRAT.

Removing High-growth Assets from an Estate:

GRATs are most useful when funded with assets that may appreciate significantly over time, such as shares of a family business, pre-IPO stocks, or other investable assets. Funding the GRAT with investable assets or cash makes valuing the transfer and investing a relatively simple process. The trustee can then invest or reallocate the assets based on the terms of the trust. Funding a GRAT with more complex assets, such as shares of a family business, is more complicated and expensive, as appraisals and valuations may be required if the price for the shares is not readily discernible.

Options for Payments:

While most people associate the term "annuity" with receiving a payment of a fixed amount, the annual payment from a GRAT can increase by up to 20% each year. By increasing the amount each year, lower payments would be received at the beginning of the GRAT term and higher payments toward the end, leaving more assets in the trust during the earlier years to potentially generate higher returns.

Income Tax Benefits:

A GRAT is treated as a grantor trust, which means that all income, gains, and losses will flow through to the grantor and be included on the grantor's personal income tax return. The benefits to this tax treatment are twofold: First, this effectively allows more wealth to shift to heirs, because neither they nor the trust will bear the responsibility of these payments. Second, the IRS has ruled that when the grantor pays the income taxes, there is no additional gift made to the GRAT.

Risks of GRATs

Mortality Risk:

In order for the appreciation in the GRAT to pass to heirs free of estate and gift tax, the grantor must survive the term of the GRAT. If the grantor passes away during the term of the trust, most, if not all, of the assets in the GRAT, and any appreciation on those assets, will be included in the estate for estate-tax calculation purposes.

Lack of Asset Appreciation:

If the assets that the grantor contributed to a GRAT do not outperform the hurdle rate, the GRAT will simply return the assets back to the grantor over the period of the trust. The good news in this scenario is that the grantor would experience minimal, if any, adverse tax consequences; however, they would have incurred fees and expenses to establish and administer a trust that did not perform successfully.

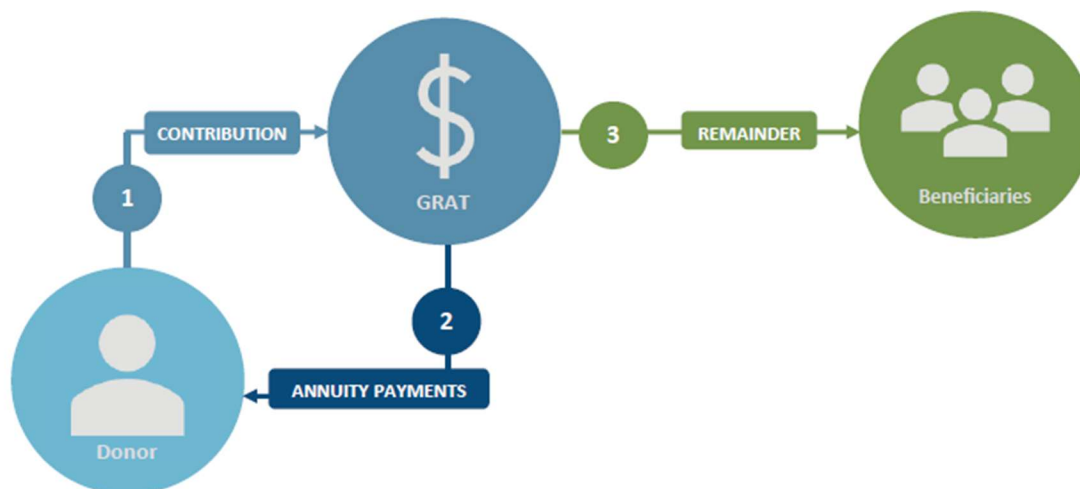
Estate Tax Law Changes:

The GRAT is such a powerful wealth transfer tool that over the years the Treasury and Congress have proposed various restrictions on GRATs, though these restrictions have not yet been implemented.

GST Tax:

GRATs present several attractive qualities, but it does not minimize or eliminate the generation-skipping transfer tax (GSTT), an additional tax that could apply to transfers made to heirs more than one generation below them. When opting to leave assets for multiple generations with the expectation that the assets will continue to grow, a grantor may wish to allocate the GSTT exemption at the termination of the GRAT or work with an attorney to address this risk. Effectively allows more wealth to shift to heirs, because neither they nor the trust will bear the responsibility of these payments. Second, the IRS has ruled that when the grantor pays the income taxes, there is no additional gift made to the GRAT.

The Grantor Retained Annuity Trust Visualized



1 CONTRIBUTION

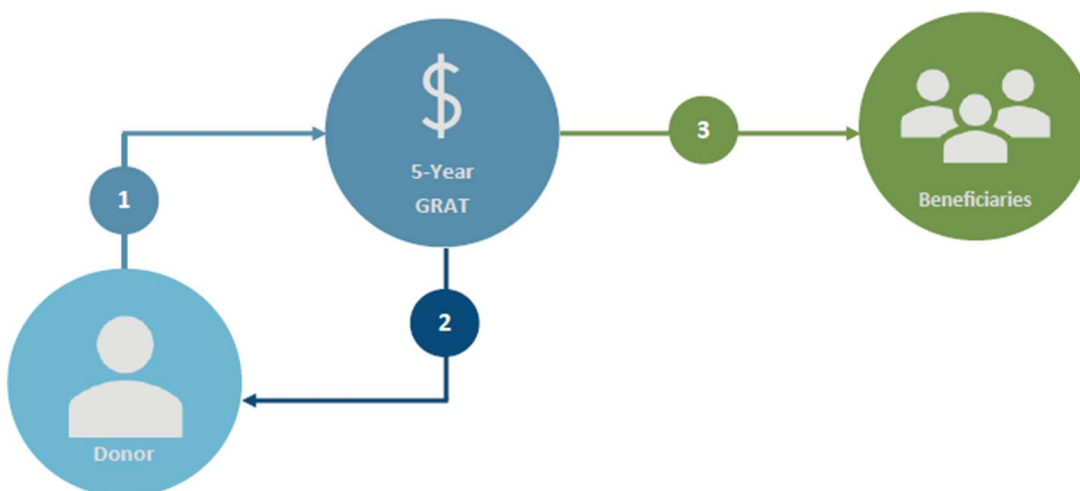
The donor makes an initial transfer into the GRAT.

2 ANNUITY PAYMENTS

The GRAT pays the donor an annual annuity amount based on the IRS Section 7520 rate at the time of funding. The GRAT pays the annuity amount to the donor for a specified period of time.

3 REMAINDER

When the GRAT terminates, the remaining assets are distributed to your designated beneficiaries free of gift tax.



1 CONTRIBUTION

The donor contributes \$1 million to a GRAT with a 5-year term. The statutory interest rate when the GRAT is funded is 1.6%.

2 ANNUITY PAYMENTS

Based on the statutory rate, the GRAT will make five annual annuity payments of \$209,701 to the donor for a total return of \$48,504.

3 REMAINDER

At the end of the GRAT term, the excess beyond \$48,504 is paid to the remainder beneficiaries.