Grantor-Retained Annuity Trusts

A grantor-retained annuity trust (“GRAT”) is a vehicle used to transfer assets to children or grandchildren at a reduced gift tax cost.

Qualified GRATs

To create a GRAT, you contribute assets to an irrevocable trust under which you retain the right to a specified annuity payment for a fixed term of years. At the end of the term of years, your annuity payments end and the beneficiaries you designated in the trust receive the remaining trust assets. For gift tax purposes, upon contributing assets to the trust the value of your gift is equal to the actuarial value of the beneficiaries’ remainder interest in the trust assets. The gift made is usually substantially less than the assets’ current value. If you survive the trust’s fixed term and the trust assets appreciate at a rate faster than the “applicable federal rate” (the IRS rate used to determine the present value of the remainder interests) that is in effect at the time you fund the trust, the “excess return” is shifted to the remainder beneficiaries free of gift tax at the end of the fixed term.

Trust Details

GRATs are usually scheduled to end well within your normal life expectancy because if you do not survive the term of years, then most, if not all, of the trust assets revert to your estate. You may fix the annuity amount as a dollar amount or as a percentage of the value of the trust assets on the date you transfer them to the trust. The annuity amount must actually be paid to you or for your benefit; it is not sufficient that you have the right to withdraw this amount from the trust. The annuity cannot be paid by means of a promissory note.

Gift Details

When you transfer property to a GRAT, several factors may impact the value of the gift, including your life expectancy at the time of transfer, the length of the fixed term, the annuity payout level, and the current applicable federal rate. For example, if a 60-year-old person transferred LLC interests with a value of $100,000 to a GRAT and retained a 6 percent annual annuity payment for 10 years (or the person’s lifetime, if shorter), the value of the gift of LLC interests in the GRAT at an applicable federal rate of 5 percent would be approximately $56,800. In contrast, if the person set the annuity payout at 10 percent, the value of the gift to the remainder beneficiaries would decrease to approximately $28,000.

If the trust assets produce an extraordinarily high cash flow or are expected to appreciate rapidly, it may be possible to create a trust, retain an annuity interest with a present value equal to (or close to) the full value of the trust, and, at little risk, pass the extraordinary growth to family members free of estate and gift tax or at a very low cost. For example, if the trust term is 10 years and the applicable federal rate is 5 percent, a GRAT annually paying you 12.95 percent of the value of the trust assets at the time of transfer may qualify for a “zero-value” gift to the remainder beneficiaries. This approach is aggressive and may be challenged by the IRS, but it illustrates a use of a GRAT that some taxpayers are currently finding attractive in appropriate circumstances.

Summary of Advantages of a GRAT

GRATs may be attractive for tax reasons if you (1) are confident that the trust assets will appreciate at a rate considerably faster than the applicable federal rate or (2) are not willing to make an outright gift but are willing to commit today to give up all interest in the assets at a stated date in the future. GRATs may also be attractive for nontax reasons if you have assets that you want to keep in the family, even if the assets consistently underperform the applicable federal rate.

The types of assets that are typically used to fund GRATs include limited-partnership interests, LLC interests, and stock of an S corporation. A GRAT is a permissible S corporation shareholder. By contributing nonvoting interests or stock, you can retain control over management while effectively transferring equity interests.

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