

Grantor Retained Annuity Trust (GRAT)

A grantor retained annuity trust may be an effective means for a client who wants or needs to retain all or most of the income from a high-yielding and rapidly-appreciating property to transfer the property to a child or other person with minimal gift or estate tax. GRATs are particularly indicated where the client has one or more significant income-producing assets that he or she is willing to part with at some specified date in the future to save federal and state death taxes and probate costs, to obtain privacy on the transfer, and to protect the asset against the claims of creditors.

A GRAT is created by transferring one or more high-yield assets into an irrevocable trust and retaining the right to an annuity interest for a fixed term of years or life. When the retention period ends, assets in the trust (including all appreciation) go to the named “remainder” beneficiary(ies). In some cases other interests, such as the right to have assets revert back to the transferor’s estate in the event of the transferor’s premature death, may be included.

GRATs provide a fixed annuity payment, usually expressed as a fixed percentage of the original value of the assets transferred in trust. For example, if \$100,000 is placed in trust and the initial annuity payout rate is 6 percent, the trust would pay \$6,000 each year, regardless of the value of the trust assets in subsequent years. If income earned on the trust assets is insufficient to cover the annuity amount, the payments will be made from principal. Therefore, the client-transferor is assured steady and consistent payments (at least until principal is exhausted).

All income and appreciation in excess of that required to pay the annuity accumulate for the benefit of the remainder beneficiary(ies). Consequently, it may be possible to transfer assets to the beneficiary(ies) when the trust terminates with values that far exceed their original values when transferred into the trust and, more importantly, that far exceed the gift tax value of the transferred assets.

The gift tax value of the transferred assets is determined at the time the trust is created and funded using the “subtraction method.” The gift tax value is determined by subtracting the value of the annuity interest (and, in some cases, other retained interests, such as the right to have the assets revert back to the transferor’s estate if he or she does not live the entire term of the trust) from the fair market value of the assets transferred in trust. How the annuity interest and any other retained interests are valued depends on who the

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remainder beneficiary(ies) is (are) and who retains the annuity and other interests relative to the transferor.

Since the GRAT permits payment of both income and trust principal to satisfy the annuity payments you have retained, the GRAT should be treated as a grantor trust for income tax purposes. This means you (the transferor-annuitant) are taxed on income and realized gains on trust assets even if these amounts are greater than the trust's annuity payments. This further enhances this tool's effectiveness as a family wealth-shifting and estate-tax-saving device. In essence you are effectively allowed to make gift tax-free gifts of the income taxes that are really attributable to assets backing the remainder beneficiary's interest in the trust.

Notice - This information is not legal advice or counsel absent an extant attorney-client relationship with the recipient; this information does not create an attorney-client relationship. Seek legal counsel before taking any action on the matters referenced above.