

GRANTOR RETAINED ANNUITY TRUSTS

GRITS, GRATS, GRUTS: SOUTHERN FOODS, GUTTERAL EXPRESSIONS ... OR WHAT? I am enamored with GRATs. If the situation fits -- the GRAT can transfer literally millions of dollars tax free to your children. The GRAT is a trust which transfers all of the appreciation in an asset over the current interest rate to ones children (or other beneficiaries) tax free.

Let's start at the beginning and look at what this acronym stands for and how it works. GRAT is an acronym for a Grantor Retained Annuity Trust. A GRAT is a trust from which the Grantor receives a fixed dollar amount each year for the term of the trust.

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In a GRAT the Grantor creates a trust and provides that the trust will pay him a fixed dollar amount each year for the term of the trust. The fixed dollar amount paid to the Grantor each year is called an annuity. The annuity is set at a percentage of the value of the assets held in the trust. For example, if you transfer \$1 million to the trust and provide that you will receive a 8% annuity, the trust will pay you \$80,000 per year. You pick the term, you pick the annuity, you pick the property to go into the trust.

Who are the players in a GRAT? Let's assume you are creating a GRAT and transferring \$1 million to the GRAT. You are the Grantor of the GRAT. You can also be the Trustee of the GRAT. You are also the only beneficiary of the GRAT

for as long as the GRAT lasts. At the end of the term of the GRAT, the trust terminates and the property passes to anyone you designate, e.g. your children. You would be the present beneficiary and your children would be the remainder beneficiaries.

So what is the benefit of the GRAT? When you create a GRAT you have made a gift to your children of the value of receiving the property at the end of the term of the trust. The gift is valued according to actuarial tables using the current federal income tax rate. The amount of the gift may be much less or

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much more than is actually transferred to your remainder beneficiaries. Your objective is to actually transfer more than the IRS table show that you would transfer.

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The amount that the IRS determines is a gift is dependent on several factors. First, the term of the GRAT (how long the GRAT continues to pay the annuity to the Grantor). Second, the amount of the annuity paid to the Grantor. Third, the current interest rate is. An actuarial computation is made based on the interest rate in the month the GRAT is created to determine the value of the remainder interest at the end of the term of the GRAT. This amount is a gift at the time the GRAT is created. The government sets a new interest rate each month. For example in March, 1997 the interest rate to be used was 7.8% and in July, 2003 the interest rate to be used was 3.0%. The value of the annuity payments is determined and subtracted from the value of the property transferred to the GRAT to determine the value of the gift.

If you are older, then the likelihood that you will die during the term decreases the

You can also be the Trustee of the GRAT.

value of your income interest and increases the value of the gift. Let's look at some examples. If the current interest rate is 8% and at age 50 you set up a 20 year GRAT funding it with \$1 million, paying yourself an 8% annuity of \$80,000 one time a year, the value of the gift to your children is \$269,360. You will report this as a gift and pay the tax on the gift upon the creation of the trust. If the property you transfer to the trust retains its value and yields an income of 8% your children will receive \$1 million in 20 years with no additional tax owed at that time. If the property also increased in value at

2% per year, your children would receive property valued at almost \$1.5 million in 20 years. The GRAT enables you to transfer the return on property in excess of the current interest rate gift tax free.

What if you die during the term? The property which is held in the trust at the time of your death is included in your estate and your gift tax is credited against your estate tax. In other words, no win, no lose --- except the loss of the use of the money paid in gift tax.

First rule: set the term for a period which is less than your life expectancy.

The following chart shows the difference in the amount of the gift when \$1 million is

A GRAT enables you to transfer all appreciation over the current interest rate at no transfer tax.

transferred to a GRAT when some of the variables in the GRAT are changed.

Term	Annuity	Gift
10	8%	\$ 480,440
10	15%	\$ 25,825
15	8%	\$ 349,832
15	12%	\$ 24,748
20	8%	\$ 269,360
20	10%	\$ 86,700

The IRS assumes that your property will yield a return equal to the current interest

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rate. If the property does yield an amount equal to the interest rate at the time the GRAT is created, then you have given your children exactly what the charts reflect you would and on which you paid a gift tax. If your property has a return rate greater than the current interest rate, then you transfer more to your children (or other beneficiaries) than the amount on which you paid a tax.

Second rule: only create a GRAT if your property has a return rate greater than the current interest rate. Actually your children will receive slightly less than that amount since the gift is increased by the likelihood that you will die during the term.

Now let's assume that your property has a return equal to 12% per year. 12% is the return on the stock market over a 20 year period. If you create a GRAT for a term of 20 years funding the GRAT with assets valued at \$1 million, the value passing to children in 20 years is shown in the following chart assuming an annuity of 8% and an annuity of 10%. Either of the GRATs transfer a significant amount of property to your children tax free.

Annuity on \$1 Million	Annuity	Gift	Value passing to children in 20 years
8%	\$ 80,000	\$ 269,360	\$ 2,191,123
10%	\$100,000	\$ 86,700	\$ 1,485,947

What if the property declines in value? If the property declines in value, then more

Second rule - only create a GRAT if your property has a return greater than the current interest rate.

of the property will be returned to you and less property will be distributed to your children. If the property declines in value then you will have paid a gift tax on property your children never received.

Third rule: Set the annuity and term so that the gift to your children is determined to be close to zero.

Now you have the basics, let's look at some situations in which the GRAT can transfer literally millions to your children at a nominal gift tax cost.

Scenario #1 - Highly appreciating property

Let's assume you have some property which has a return of 20% or greater which is relatively stable. This asset could be the interest in a business, stocks or real estate. One example may be a piece of commercial real estate valued at \$2 million. The real estate generates \$300,000 per year in net revenue and is appreciating at about 5% per year. Assuming a current interest rate of 8%,

the third rule - set the annuity and term so that the gift to your children is determined to be relatively small.

you could transfer the property to a 10 year GRAT with an annuity of 15%. Assuming you are 50 years old, the gift would be valued at \$25,825. The \$300,000 would be paid to you each year. At the end of the 10 year period, your children would receive the property valued at that time at \$4,886,684 with no additional tax cost. In this situation for about \$14,200 in tax you have transferred \$4,886,684 to your children. In actual practice, the annuity amount is set so that

the value of the gift is zero or a very small amount, such as \$1,000.

Scenario #2 - Likely jump in the value of the stock

Let's assume you have a business valued at \$4,000,000 that is seeking to obtain a contract for a new business venture. If the contract is obtained, the value of the business will increase two to three fold in the next two years. If the contract is obtained, you would like to transfer 1/4 - 1/2 of the stock to your children. Since all of the appreciation would occur in the next two years, you have elected to create a short term GRAT. Let's assume the entire amount of the appreciation occurs in the first year prior to the payment of the first year's annuity and no appreciation occurs after that time. Let's assume that 45% of the stock is transferred to the GRAT. For purposes of this illustration, no discounts are taken for minority interest or lack of marketability, thus the stock which is transferred to the GRAT is valued at \$1.8 million. The GRAT continues for 5 years and the annuity is set at 25% with the following result. The annuity will be set at \$450,000 per year. If no dividends are paid on the stock, a portion of the stock will have to be transferred each year to the Grantor to pay the annuity. The value of the gift for gift tax purposes will be \$17,000. If the stock has large dividends or is an S corporation with sufficient cash flow to pay the annuity, then the fact that the stock will be discounted significantly increases the benefits derived from this trust.

If the stock doubles in value the stock remaining in the GRAT at the end of the five year term will be valued at \$1,350,000. If the annuity is paid with stock each year, the GRAT will own about 16.875% of the stock of the company and

In this situation for about \$14,200 in tax you have transferred \$4,886,684 to your children.

the Grantor will own the remaining 83.125% of the stock of the company. If the stock triples in value the stock remaining in the GRAT will be valued at \$3,150,000. In this situation, the GRAT will own about 39% of the stock in the company and the Grantor will own about 61% of the stock of the company.

Scenario #3 - Investment of high risk/high return

As a part of your investment portfolio you invest in high risk, high return stocks. Some of these stocks are invested in emerging markets, some in small caps and some in foreign stocks. The fluctuations on these markets can be dramatic so if the term of the trust is 10 years it will hit some upswings and some

In this situation you have transferred \$1,350,000 to \$3,150,000 to your children for a cost of about \$9,000 in tax.

downswings in the market. Some of these high risk stocks will go up while others go down. To avoid losing the benefit of an upswing which is followed by a downswing in a market, the trust term is set for a short period, e.g. two years.

To prevent losing the benefit of an upswing in one group of stocks from a downturn in another stock, each group of stocks is held by a separate trust. You create three two year GRATs and transfer each of your portfolios, e.g. emerging markets, small caps and foreign stocks into a separate GRAT. You own \$5 million of stock in each portfolio. Assuming the following returns, each GRAT transfers the following value to your children at the end of the two year term.

Asset	Value	Return	Gift	Value at end of term passing to children
stock portfolio A	\$5M	40%/yr	\$25,015	\$3,700,000
stock portfolio B	\$5M	20%/yr	\$25,015	\$1,150,000
stock portfolio C	\$5M	5%/yr	\$25,015	\$0

If you create new trusts every two years when these trusts terminate, your GRATs are referred to as “rolling GRATs”.

You probably will not be surprised that the IRS does not like GRATs. The structure of the GRAT is set forth in the statute, so these trusts are not something that is someone’s idea - waiting to be tested. The IRS took note when they realized that literally millions of dollars have been and are being transferred without transfer tax using GRATs. The IRS is particularly concerned about the use of short term GRATs with “high payout”, in other words, the GRATs which are designed to last a short period of time, have a large annuity which results in a nominal gift. Why? Because they do transfer large amounts tax free, with little risk of a volatile market

and little risk of the Grantor dying during the term.

GRATs are a very safe way to transfer highly appreciating property since a redetermination of the value of an asset transferred does not result in a large gift. For example, let’s say an interest in a closely held business was valued at \$1 million. On audit, the fair market value is determined to be \$2 million. By doubling the amount of the gift, the gift may be increased from \$1,000 to \$2,000. The main impact is that the annuity paid to the grantor is doubled, thus making the GRAT less effective at transferring property to the remainder beneficiaries but does not risk having the grantor owe a large gift tax.