

GRANTOR RETAINED ANNUITY TRUST (GRAT)

(Permits Grantor to retain qualified annuity interest in trust while transferring remainder to next generation at a discount for estate and gift tax purposes.)

HIGHLIGHTS OF THE PLAN

OVERVIEW

Code Section 2702 requires that retained interests in a split-interest gift be valued at zero unless it is a qualified retained interest. In other words, split-interest gifts of remainder interests must be valued at the full fair market value of the property subject to the split-interest gift unless they are made in the form of a grantor retained annuity trust, grantor retained unitrust, nondepreciable tangible personal property, personal residence trust, or qualified personal residence trust.

A grantor retained annuity trust (GRAT) permits the Grantor to transfer property to an irrevocable trust for a fixed term of years and retain an income interest in the form of an annuity. The remainder interest is transferred to the next generation at a discount for estate and gift tax purposes if the Grantor lives for the full term of his or her interest in the trust. If the Grantor dies during the term of his or her interest in the trust, the full value of the trust assets will be included in the Grantor's estate for federal estate tax purposes. Life insurance in a life insurance trust should generally be purchased to protect against any estate taxes that might be due if the trust assets are included in the Grantor's estate.

The best assets for use in a GRAT are assets that are likely to appreciate in value. Using such property to fund the trust allows for greater leverage of the transfer tax discount. When using property other than cash or publicly traded securities to fund the GRAT, the Grantor should have the property to be transferred appraised by one or more qualified appraisers.

One popular technique involves creating a two-year GRAT in which the present value of the remainder is close to zero, which means that little or no gift tax occurs. If publicly traded stock is used to fund the GRAT and the trustee is required to pay the grantor two annual payments, the trustee can pay the grantor the annuity in two annual payments of stock. If the value of the stock goes up, the stock not needed to pay back the grantor is transferred at the end of the fixed term of the trust to the remainder beneficiaries at no transfer tax. If the value of the stock goes down or remains even, the grantor gets back all the stock, in which case nothing is gained, but the grantor is no worse off than if he/she had held the stock outright.

ADVANTAGES OF A GRAT

1. The grantor or other applicable family member (AFM) keeps a retained interest in the GRAT, a qualified annuity interest (fixed percentage of trust assets as valued when transferred to the trust) payable at least annually.

2. If the grantor lives for the entire term of the trust, the property placed in the GRAT is transferred at a discount for transfer tax purposes. Properly structured, the value for transfer tax purposes can be near, but not quite, zero.
3. If the grantor lives for the entire term of the trust, all appreciation on trust assets escapes transfer tax.
4. If a GRAT has a "defective grantor trust" provision, such as the power in the grantor to substitute assets in the trust of equal value, the GRAT can qualify to hold S corporation stock.
5. The discount features of a GRAT can be combined with the discount features of a minority interest in a closely held corporation or family limited partnership to multiply the transfer tax discounts. Keep in mind that valuation is always an issue with this kind of property.
6. A GRAT can be structured to pay an annuity interest to the grantor and successively to the grantor's spouse if the grantor dies during the fixed term of the trust. However, the spouse's share does not qualify as a qualified annuity interest and is ignored for purposes of calculating the annuity and remainder interests.

DISADVANTAGES OF A GRAT

1. If the grantor dies during the fixed term of the trust, the full value of the trust assets are included in the grantor's estate.
2. Once the trust term ends, the assets will automatically be transferred to the remainder beneficiaries.
3. If assets in the GRAT do not appreciate in value, the transfer tax leverage of removing the growth on the assets from the grantor's estate is lessened.
4. The gift to the remainderman is a gift of a future interest and does not qualify for the gift tax annual exclusion.