GRANTOR RETAINED ANNUITY TRUSTS (GRATs)

A Grantor Retained Annuity Trust is a technique which enables a person to transfer property to younger family members at a significantly reduced transfer tax cost while retaining an income interest for a specified period of time.

A. Typical Transaction

The Grantor transfers real or personal property (e.g., a partnership interest) to an irrevocable trust and reserves the right to receive annual distributions from the trust for a specified term. After the specified term of years has expired the property is distributed to, or held in trust for, the family member beneficiaries.

B. Tax Consequences

1. Income Tax Consequences
The Grantor is taxed on income distributions received from the trust during the period of the retained income interest. The trust is taxed on any trust income not distributed. Principal distributions to the Grantor are not taxed.

2. Gift Tax Consequences
The Grantor has made a gift of the property transferred into trust but the value of the gift is only a fraction of the fair market value of the property.

a. The amount of the gift is the fair market value of the property transferred reduced by the Grantor's retained income interest determined by the IRS tables (i.e. the longer the income interest and the higher the rate of return the smaller the gift).

b. The gift takes place at the time the property is transferred into trust. No further gift occurs when the property is distributed to the family member beneficiaries, regardless of any increase in value of the property at that time.

c. Generally, no gift tax will be payable although a portion of the Grantor's unified estate and gift tax credit will be used.

3. Estate Tax Consequences
If the Grantor survives the specified term of the income interest, the entire value of the trust, including any appreciation, will be excluded from his or her estate at death.

a. If the Grantor dies during the specified term of the income interest, all or a portion of the value of the property will be includable in his or her estate.

b. Even if the property is includable in the Grantor's estate, a marital deduction may be available to postpone taxes until the death of the Grantor's spouse.

4. Illustration
(The exact figures of which will depend on the then-applicable interest rate.) A 55 year old Grantor who transfers property worth $1,000,000 into a Grantor Retained Annuity Trust (GRAT) and reserves an annual annuity of $60,000 for 15 years will have made a gift of approximately $234,000 (not $1,000,000). No gift tax will be paid but the Grantor will have used $234,000 of his or her $534,000 (beginning in 2014) gift tax applicable exclusion amount. At the end of 15 years, the property will be distributed to or held for the benefit of the Grantor's family member beneficiaries. If the Grantor's death occurs at age 70 when the property, in the hands of the beneficiaries, is presumably worth $2,226,314, the Grantor's estate tax savings could exceed $890,000. The savings result from the use of the GRAT and the normal benefits of giving away property that appreciates in value.

C. Advantage of Funding with High Yield Investments

1. The use of a Grantor Retained Annuity Trust (GRAT) is most suitable in situations where the trust can be funded with high yield investments as illustrated by the following examples (assuming the applicable interest rate for valuing such trust is 2.2%, January 2014 7520 rate):

a. A 6% interest retained by the Grantor at age 55 for 15 years in a GRAT results in only 23% of the contribution to the trust being considered a gift.

b. A 7% interest retained by a Grantor at age 55 for 15 years in a GRAT results in only 11% of the contribution to the trust being considered a gift.

c. A 8% interest retained by a Grantor at age 55 for 15 years in a GRAT results in none of the contributions to the trust being considered a gift.

2. Contributions to a GRAT of S Corporation stock, limited partnership interests or other partial interests with applicable discounts will help produce a high-yield investment. For example, assume that (i) a limited partnership interest worth $1,000,000 in the hands of the Grantor which yields a 7% return (i.e. $70,000 per year) and appreciates at 3% is given to a GRAT; and (ii) the appropriate discount in valuing the gift of the limited partnership interest is 30%. The net result is that a gift valued at zero with a $70,000 annual return for 15 years produces an estate tax savings of approximately $750,000.

D. Tangible Personal Property

Tangible personal property, such as artwork, can be used to fund Grantor Retained Income Trusts (GRITs). The estate and gift tax savings of GRITs funded with such assets are even more significant than the tax savings resulting from GRATs funded with investment assets.

E. Short Term GRAT

A Short Term GRAT (e.g., a 2-5 year term with a very high retained interest) may be used to transfer growth in an investment with little or no gift tax consequences and very little tax risk.

For example, the contribution of a $1,000,000 asset to a 3 year GRAT requiring a payment to the Grantor (assumed to be age 55) of 36% per year, payable out of principal (i.e. part of the asset transferred) if the income is insufficient, would result in a gift valued at zero.

1. Over the 3 year period the Trust would return to the Grantor $1,080,000 ($360,000/year), the amount of the initial contribution plus $80,000 in earnings or growth.

   a. If there is no more than ordinary earnings and no growth in the value of the asset, the Grantor would have his entire contribution back and would have gained nothing.

   b. If there are extraordinary earnings and/or growth in the value of the asset, the increased value would be transferred to the remainder beneficiaries at zero gift tax cost.

2. As the Grantor receives a return of principal (i.e. part of the asset originally transferred) as part payment of the $360,000 distribution, he or she could re-contribute that portion of the asset to a new Short Term GRAT.

F. Ability to Create a "Zeroed-Out" GRAT

In the past, the IRS has taken the position that a taxpayer could not create a "zeroed-out" GRAT, i.e. a GRAT that resulted in the value of the gift being equal to zero. It has been the IRS's opinion that no matter how large the annuity payments were, a minimum value still must be assigned to the gift (based upon certain actuarial assumptions). A recent landmark Tax Court case overruled the IRS regulations and held that, if properly designed, a gift to a GRAT could result in the value of the remainder interest (i.e. the value of the gift) being equal to zero.