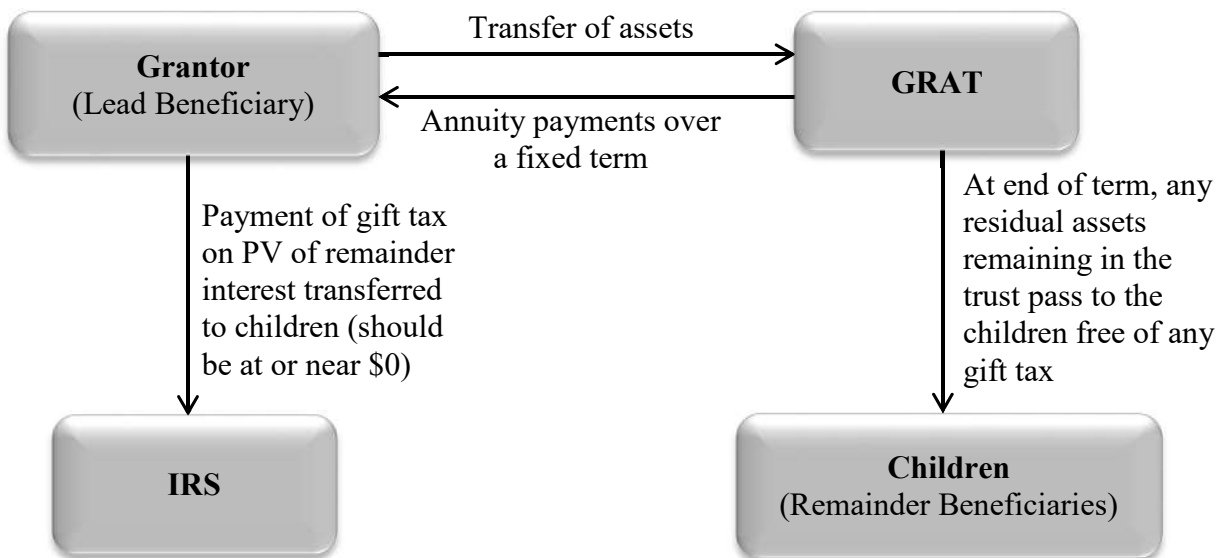


## #21: Grantor Retained Annuity Trust (GRAT)

A GRAT is a split-interest trust in which the grantor retains an annuity interest for a term of years. At the end of the annuity term, any assets remaining in the trust pass to the remainder beneficiaries, typically the grantor's children. The amount of the taxable gift is the value of the property transferred to the trust minus the present value of the lead annuity interest retained by the grantor. The value of the lead interest can be set equal to the full value of the property transferred, creating a "zeroed-out GRAT" with no taxable gift. However, grantors generally leave a minimal taxable gift to start the statute of limitations and to avoid a possible argument that the GRAT has no substance because the grantor didn't transfer any value under the relevant IRS tables.



### Transfer Tax Benefits

The transfer tax benefits of a GRAT are produced by interest rate arbitrage. If a zeroed-out GRAT produces a total return equal to (or less than) the assumed interest rate (IRC § 7520 rate), there will be nothing left in the GRAT at the end of its stated term. The remainder interest will be valued at, and actually worth, zero. However, if the GRAT assets produce a return in excess of the IRC § 7520 rate, property will remain in the GRAT at the end of its term to pass tax-free to the remainder beneficiary. This is shown in the following examples.

**Example 1.** Assume that Taxpayer (T) transfers \$1,000,000 to a zeroed-out, 4-year GRAT when the IRC § 7520 rate is 5.2%. The annual payout needed to zero out the GRAT is \$283,326. Assume that the actual return produced by the trust is 2.2%. Operation of the GRAT is shown below.

Year	Beg. Balance	Return (5.2%)	Payout	Ending Balance
1	\$1,000,000	\$52,200	\$283,323	\$768,677
2	\$768,677	\$39,971	\$283,323	\$525,325
3	\$525,325	\$27,317	\$283,323	\$269,319
4	\$269,319	\$14,005	\$283,323	\$0

**Example 2.** Assume the same facts as in Example 1 except that the GRAT assets produce an actual return of 10%. The operation of the GRAT is as follows:

Year	Beg. Balance	Return (10.0%)	Payout	Ending Balance
1	\$1,000,000	\$100,000	\$283,323	\$816,677
2	\$816,677	\$81,668	\$283,323	\$615,022
3	\$615,022	\$61,502	\$283,323	\$393,201
4	\$393,201	\$39,320	\$83,323	\$149,198

The higher the total return produced by the GRAT, the larger the tax-free transfer. The following chart shows the tax-free transfers for a \$1,000,000 zeroed-out GRAT for various after-tax rates of return for the GRAT assets, assuming the same general fact pattern as in Examples 1 and 2.

2.2%	\$0 <sup>71</sup>
5.2%	\$0
6.0%	\$23,033
8.0%	\$83,789
10.0%	\$149,198
15.0%	\$334,252

### Income Tax Benefits

Although some planners add special grantor trust provisions, a GRAT's basic structure should make it a grantor trust. It should be a grantor trust with respect to income because the settlor retains an income interest in the trust. It should be a grantor trust with respect to corpus because if income is insufficient to make the annual annuity payments, corpus must be used.

Since GRATs are grantor trusts, all GRAT income is reported on the grantor's Form 1040; thus, the grantor pays the GRAT's income tax liability. This produces an additional tax-free transfer to the remaindermen, enabling the GRAT assets to grow at their pre-tax rate of return. To illustrate, suppose that one of the GRATs we have been considering produces a pre-tax return of 10% and an after-tax return of 8%. As the chart above indicates, having the grantor pay the trust's income tax increases the tax-free transfer from \$83,789 to \$149,143.

### Planning with GRATs

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<sup>71</sup> If the trust return is less than 5.2%, the trust assets will simply be depleted. There is no requirement for the grantor to make up any shortfall.

GRATs are generally most favorable when the IRC § 7520 rate is low. The lower this rate is, the easier it is for trust returns to exceed it and produce tax-free transfers.

Another important consideration in structuring GRATs is to ensure that the grantor survives the term of the trust. If the grantor dies prematurely, the full value of the trust assets is generally included in the grantor's estate, thereby eliminating any transfer tax benefit. Therefore, GRATs are generally given a short term.

GRAT benefits can be enhanced in a number of ways. One strategy is to create multiple GRATs to separate favorable returns from unfavorable returns to prevent losses and gains from netting each other out.

**Example 3.** T transfers \$1,000,000 worth of Asset A and \$1,000,000 worth of Asset B to a four-year GRAT described above. Asset A produces a -10% return and Asset B produces a +10% return. The net return for the GRAT is zero and, therefore, there is no tax-free transfer. If, however, T had created separate GRATs for the two assets, i.e., GRAT 1 for Asset A and GRAT 2 for Asset B, T would have produced a tax-free transfer of \$149,183 (\$0 for GRAT 1 and \$149,183 for GRAT 2). Note that although GRAT 1 would be underwater at the end of its term, there is no obligation for a GRAT to make up any shortfalls; the GRAT simply dries up when it runs out of assets.

Another strategy is to create a series of short-term rolling GRATs to minimize mortality risk and put more assets to work; i.e., when the grantor receives a payment from a GRAT it is immediately contributed to a new GRAT. Suppose, for example, that a grantor can choose between a single 10-year GRAT and a series of nine two-year GRATs. If the grantor dies after the end of year 9 under the first alternative, the full value of the GRAT would ordinarily be included in the grantor's estate and there would be no tax-free transfer. By contrast, if the grantor uses rolling GRATs, any excess growth from the first eight GRATs has already passed to the remaindermen, tax-free.

A third strategy is to back load payments by up to 20% as permitted in the IRC § 7520 regulations. Assuming that the trust return exceeds the IRC § 7520 rate, back loading increases the amount of the tax-free transfer by allowing more value to grow in the GRAT during its early years.

**Example 4.** Assume the same facts as in Example 2, except that the GRAT has a 20% increasing payout feature. The tax-free transfer increases from \$149,198 to \$162,473, an improvement of \$13,275.

Year	Beg. Balance	Return (10.0%)	Payout	Ending Balance
1	\$1,000,000	\$100,000	\$213,557	\$886,443
2	\$886,443	\$88,644	\$256,268	\$718,820
3	\$718,820	\$71,882	\$307,521	\$483,180
4	\$483,180	\$48,318	\$369,026	\$162,473

Although discounted assets can be contributed to a GRAT, their usefulness is limited. With the typical short-term GRAT, the bulk of each annuity payment must be made in kind with the assets

used to fund the trust. The same discount applies to the assets when they are distributed, netting out any benefit of discounting.

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