GRATS: Grantor Retained Annuity Trusts

Passing Along Assets Free of Estate and Gift Taxes

By Quinto AMBROSETTI, CFP®
Principal, Senior Financial Advisor

Key points:

- *A GRAT lets you transfer assets to your heirs in a trust that generates income for you in the form of an annuity.*
- *It is a tax-advantaged way of passing wealth to your heirs.*
- *The combination of current low interest rates and depressed stock values make it a good time to transfer assets to a GRAT.*

GRANTOR RETAINED ANNUITY TRUSTS, or GRATs, are financial tools that wealthy people use in estate planning to pass assets to their children while avoiding estate and gift taxes. A GRAT is an irrevocable trust, and when you transfer property to the GRAT, you are making a taxable gift to your beneficiaries. But the value of the gift is discounted because of the interest in it that you retain, typically in the form of annuity payments to yourself. The discount is calculated using IRS valuation tables that assume the property in the trust will realize a modest rate of return during the term of the GRAT. If the property in the trust grows more than the IRS's "hurdle" rate, the excess growth passes to your "remainder" beneficiaries gift-tax free.

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TAX ADVANTAGES ASSOCIATED WITH A GRAT

- The taxable value of the gift is reduced. The present value of the grantor's retained interest in the property is subtracted from the total value of the property at the time of transfer to determine the amount of the gift subject to gift taxes. The gift is discounted based on the IRS's 7520 rate — also known as the hurdle rate — in effect during the month of the gift to the trust. Any gift tax due can be offset by the grantor's available gift and estate tax exclusion amount: $11,580,000 in 2020, plus any deceased spousal unused exclusion amount. However, a GRAT can be structured so the retained interest is equal to the value of the transferred property, in which case there are no gift-tax consequences, a "zeroed-out" GRAT.

A GRAT can be used to avoid a will contest, public scrutiny of the assets, or an election against will.

- Property transferred to a GRAT will not be included in the grantor's gross estate as long as he or she outlives the term of the retained interest.
- Appreciation in and any earnings generated by the property after being transferred to the GRAT will also not be included in the grantor's gross estate.

  For example: You transfer an investment portfolio worth $1 million to a GRAT that will pay you $104,000 at the end of each year for 10 years, based on the June 2020 Section 7520 rate of 0.6 percent. The investment portfolio earns a seven percent annual return over the 10-year term. About $530,000 will pass to your remainder beneficiaries.

WHEN TO USE A GRAT

A GRAT generally works best for people who are expected to outlive the GRAT term, and who have enough other assets to maintain their lifestyle when the annual annuity payments end.

Further, a GRAT should be considered if:

- The grantor has property that is expected to appreciate significantly in the short term.
- The grantor has property such as closely held stock, high-growth investment portfolios, and real estate that have the potential to outperform the Section 7520 rate.
- The grantor does not want to pay federal gift tax and has already used up his or her applicable estate and gift tax exclusion.

ADVANTAGES OF USING A GRAT

- *The value of property remaining in a GRAT will not be included in the grantor's gross estate as long as grantor outlives the term.* As long as the grantor outlives the term of years set out in the trust document, the property — principal and interest — remaining in the trust will not be included in the gross estate of the grantor for estate tax purposes. The grantor need only outlive the term for one day. Thus, a GRAT can be an excellent vehicle for transferring appreciation in the property's value gift- and estate-tax free.
- *A GRAT can be used to avoid a will contest, public scrutiny of the assets or an election against will.* Property transferred to a GRAT will not be part of the grantor's probate estate. The property will be distributed to the remainder beneficiaries named by the grantor according to the terms of the trust. The grantor's other legal heirs would have no claim to them, which should discourage them from contesting the will. Furthermore, a will is a public document. Anyone can go to the probate court and view its contents. A trust is a private document.

TRADE-OFFS WITH A GRAT

- *The property in trust will not escape estate taxation if the grantor does not outlive the term of years.* Failing to outlive the term of the GRAT throws the trust property back into the grantor's estate, and the tax advantages of the GRAT are lost.

- *The GRAT may fail to outperform the Section 7520 rate.* If the GRAT property does not produce a return that exceeds the Section 7520 rate, there will be no excess to transfer and no tax savings, which defeats the purpose of the GRAT.

- *The transfer of property to GRAT does not qualify for the annual gift tax exclusion.* To qualify for the annual gift tax exclusion, the recipients of a gift must have a present interest in the gift, that is, be able to possess, use, and enjoy the gift at the time of giving. However, with a GRAT, the remainder beneficiaries will not have a present interest until the grantor's retained interest ends.

- *Property in the GRAT will not be available to the grantor during the term of years.* As with any irrevocable trust, once property is transferred to a GRAT, the grantor gives up control. If during the term of the trust, the grantor finds that he or she needs more than the annuity payment amount, he or she will be unable to access the property or change the terms.

Property transferred to a GRAT will not be part of the grantor's probate estate.

SHORT-TERM ROLLING GRAT

A rolling or cascading GRAT is a technique that involves creating a series of short-term GRATs, typically two or three years, with each successive GRAT being funded by the annuity payments from the previous ones. This technique can minimize the risk to the estate of the donor dying during the GRAT term, and can also minimize interest rate risk. During a fluctuating market, the donor with a rolling GRAT can take advantage of the markets as they change. If the market does not go up during the GRAT period, all of the GRAT is paid back to the donor. But if the market does go up, the donor benefits by the increase.

Further, whether a short-term GRAT is established during a low- or high-interest rate period, it is likely that over time the rate factor will cancel itself out. Thus, rolling GRATs can provide an ideal vehicle for single stocks — or stocks of a single style, such as growth stocks — especially if they are segregated in separate trusts. Such an asset-splitting strategy can work in both good and bad markets.

Consider a GRAT as a way to designate assets to your beneficiaries. Given current market conditions and the current IRS 7520 rate of .6 percent, it's reasonable to anticipate much greater growth in value than the hurdle rate in coming years.

The GRAT is one of many estate-planning techniques that can be used to reduce potential future taxes for your beneficiaries. We work with your attorneys and CPAs to determine which strategy is best for you. Please call me at 814-459-1116 to discuss your estate-planning opportunities.

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Quinto Ambrosetti, CFP®

Principal, Senior Financial Advisor, HBKS® Wealth Advisors

Quinto is a principal and senior financial advisor working out of the HBKS office in Erie, Pa. He works directly with clients providing comprehensive financial planning services and developing investment management strategies. He began his financial services career in 2001.