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WEALTH MANAGEMENT LLC

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Transfer of Wealth Using a Grantor Retained Annuity Trust

One method of transferring wealth to family members is through the use of a Grantor Retained Annuity Trust (GRAT). Taxpayers can use a GRAT to minimize their estate tax exposure by transferring future appreciation of trust assets to their beneficiaries. The utilization of a GRAT becomes even more effective during periods when interest rates are low. Furthermore, funding the trust with assets with higher potential for appreciation during the trust term, will obtain the best results.

What is a GRAT?

A GRAT is a structured trust arrangement with the primary goal of transferring future asset appreciation to another individual, typically a member of the grantor's family. A portion of the appreciation of the assets held in the GRAT during the trust's term escapes inclusion from the grantor's estate. In order for this strategy to be successful, there are two outcomes that must occur. First, the assets contributed to the GRAT must appreciate, during the trust's term, at a rate greater than an established Internal Revenue Service rate, referred to as the §7520 rate. Second, the grantor must survive the trust term. If the grantor dies before the trust term expires, the GRAT's assets are pulled back into the grantors estate, possibly once again subject to the estate tax.

The Internal Revenue Service's §7520 rate, which the GRAT must outperform, is reset and published on a monthly basis. The rate for each GRAT is based on the rate in effect for the month the assets are transferred to the trust. As of the date of the publication of this article, the current §7520 rate is 0.6% (a record low!) and is scheduled to drop to 0.4% for GRATs established in August 2020.

The grantor must decide on the GRAT term at the inception of the trust. Two years is the permitted minimum term and there is no maximum term length. However, because of the increased risk that the grantor may not outlive the term, most grantors do not choose a term beyond 10 years. One strategy to minimize risk of failure and provide a greater period for growth is a multiple GRAT strategy. Multiple GRATs would be established with varying terms to avoid an all-or-nothing result.

Assuming the grantor outlives the GRAT term and the assets outperform the §7520 rate, any assets remaining in the trust at the end of the GRAT term become assets of the beneficiary. Furthermore, these assets are permanently excluded from the grantor's estate and avoid gift tax upon transfer.

There are a few disadvantages to using a GRAT to be aware of. First, the transaction is irrevocable, meaning that it cannot be changed once established. Second, the assets are treated as a gift of a future interest to a beneficiary, thus no portion of the initial funding of the trust is eligible to be offset by the annual gift exclusion amount. Finally, should the GRAT fail due to death or poor investment performance of the assets, the grantor's lifetime exclusion will still be reduced by the value of the gift at the start of the GRAT term. However, given the 2020 lifetime exclusion of $11.58M per person and available trust provisions, the majority of taxpayers can accept this downside risk.

How a GRAT Works

A GRAT involves a transfer of property to an irrevocable trust, whereby the grantor retains a right to receive annual annuity payments, either a fixed amount or a percentage of the initial trust principal. The grantor also must recognize the income of the GRAT on their personal income tax return for each year of the trust term. However, if the trust had no earnings during a given year, the grantor would recognize no income. At the end of the term, the trust will terminate and any remaining assets are transferred to the beneficiary. The value of the taxable gift is determined and reportable in the year that the trust is created and funded. If the GRAT is successful, the excess appreciation accumulated over the GRAT trust term converts to a tax-free gift to the beneficiary.

The following section shows an illustrative example of how a typical GRAT can save taxes.

Illustration of Use of a Grantor Retained Annuity Trust:

Grantor George (father), decided to establish a Grantor Retained Annuity Trust for the benefit of his only son, Beneficiary Bill. George placed $1 Million of publicly traded corporate stock in the GRAT on its initial funding date. The GRAT was designed to provide annual annuity payments to George in the amount of $75,000 (7.5% of the value of the GRAT's initial $1 Million of assets), payable over ten years. At the time establishing the GRAT, the IRS §7520 rate was 0.6%

$75,000	Annual annuity payment to Grantor George	
X 9.6778	Annuity factor based on a .6% rate with a 10-year term (IRS Pub. 1457, Actuarial Table B)	
$725,835	Present Value of Annuity Stream paid to George	
$274,165	($1,000,000 - $725,835)	Value of the Remainder Interest

Now assume that the assets appreciate at a rate of 6% annually, with the same stream of annuity payments, Beneficiary Bill will receive $802,010, calculated as follows:

$1,000,000	Initial Contribution
552,010	Add: Appreciation / Earnings during trust term at 6% rate
(750,000)	Less: Annuity Stream Payments ($75,000 X 10)
$802,010	Amount paid to Beneficiary Bill

Beneficiary Bill will receive $802,010 at the end of the ten-year term, however, only the $274,165 will be considered a gift subject to Federal gift tax for Grantor George. Thus, the $552,010 of appreciation earned on the corporate securities passes to Bill free of gift tax.

Note, this is one of many scenarios where GRATs can be used to help reduce one's estate. The results could be improved with a higher earnings rate over the term of the GRAT. Lastly, the above example does not take into account the tax impact related to taxable income earned within the trust and paid by the grantor. However, the payment of these taxes further reduce the grantor's estate and are not considered additional gifts to the trust.

GRATs can be a great tool in the right situation. Should you wish to open a discussion on how a GRAT may be useful for your estate plan, please reach out to your SilverOak Wealth Management investment advisor.

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