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# GRATS: POWERFUL TOOLS FOR ESTATE PLANNING AND WEALTH TRANSFER!

**GRATs – Grantor Retained Annuity Trusts – are among the most important of all estate planning and wealth transfer tools**

## INTRODUCTION

A GRAT is an irrevocable trust into which an estate owner can place cash, stocks, mutual funds, real estate, or other income-producing property. The estate owner is the grantor (creator) of the trust. As its name implies, the grantor retains the right to annual (or semiannual, quarterly, or monthly) payments of a fixed amount of principal and interest for a fixed number of years. At the end of the period specified in the trust (which can be practically any amount of time from 2 to 20 years), the remaining trust assets will pass to the trust beneficiary – typically a child, grandchild, or other family member or friend – named by the grantor.

Keep reading and you will learn more about some of the most relevant issues, such as:

- Who should consider a GRAT.
- Why a GRAT might be a terrific estate planning and/or wealth transfer tool.
- How a GRAT works.
- Additional reasons to create a GRAT.
- The costs or downsides associated with a GRAT.
- The income tax implications of a GRAT.
- The gift tax implications of transferring assets to a GRAT.
- Problems incurred when an asset subject to indebtedness is transferred to a GRAT.
- What is a "rolling GRAT," and why it may be used.
- How life insurance may "bullet-proof" estate tax savings.

## WHO SHOULD CONSIDER A GRAT

The profile of an ideal grantor is an estate owner who has the appropriate type of asset (e.g., appreciating and income-producing) and:

- has an estate over $2,000,000 (and growing),
- is financially able, and psychologically willing, to part currently with principal and eventually with the cash flow it produces,
- is willing to make lifetime gifts to family members and/or others,
- is willing to use some or all of his/her lifetime gift tax exclusions to offset any outright gift tax,
- is highly likely to outlive the specified term of the trust, and
- acts while the Section 7520 rate is relatively low, and before the assets he/she owns reach their appreciation potential.

## ADVANTAGES OF A GRAT

When establishing a GRAT, the grantor is essentially making a gift of the right to trust assets at the end of the specified term (a gift of a remainder interest to the remainderman – the ultimate trust beneficiary). Saving gift and estate taxes are the two major objectives for establishing a GRAT, although there are many other ancillary and non-tax advantages.

In a nutshell, the GRAT allows the grantor to transfer large amounts of wealth at a significant gift tax discount.

Then, if the grantor survives the term of the GRAT – even by only one day – the value of the asset/property in the trust at that time is removed from his/her estate and thousands – even millions – of dollars of federal and state death taxes may be saved.

The following mathematical premise illustrates the gift tax discount:

> The beneficiary's right to receive money or other property X years from now is not worth as much as the right to get it today. I call it the "money value of time" principle.
>
> Under a GRAT, the gift tax liability is based on the value of the remainder interest in the hands of the ultimate recipient (trust beneficiary). So, the grantor will obtain a "discount" for gift tax purposes since his/her gift is not measured by the current value of the gift but, rather, the much lower present value of the beneficiary's right to receive the trust assets at the end of the trust term. The longer the term of the trust (i.e., the longer the beneficiary must wait to receive the trust property), the greater the gift tax discount and the lower the gift tax. By using a GRAT, the grantor may even be able to make a gift of property worth well over $1,000,000 – with no out-of-pocket gift tax cost.

## HOW A GRAT WORKS

Let us assume Johnson Wax is 60. He has an estate of about $10,000,000 and has an extremely well managed portfolio consisting of $1,000,000 of stocks that are both appreciating (a 6 percent net growth per year) and pay a sizeable dividend (about 4 percent net). He wishes to remove both the appreciation and principal from his estate but wants a steady and consistent income for at least the next 10 years. Because of the federal estate tax, if he does not remove the stocks from his estate, his heirs, Bea and Ella Quince, may lose as much as 50 cents of every dollar Johnson Wax leaves them to death taxes. He is in the maximum bracket for federal gift tax purposes, so he is hesitant to make an outright gift of the stocks.

Wax sets up a GRAT. He puts $1,000,000 of income-producing assets in the trust and retains the right to a fixed annuity from the GRAT for 10 years. He wants an annuity with a fixed payout equal to 7 percent of the initial $1,000,000 value of the trust, and that $70,000 annuity each year would be paid regardless of how much income the trust actually produces during the 10-year trust term.

Assuming a 3.8 percent federal discount rate (the so-called Section 7520 rate), the actuarial factor for each dollar of the annual annuity Wax retains is 8.1923. Multiplied by the $70,000 a year, the interest he has retained (the right to $70,000 per year for 10 years) is worth $573.461. This means the value of the remainder interest, the gift he is making to the ultimate trust beneficiaries (his children), measured as of the date the trust is funded, is only $426,539 ($1,000,000 minus $573,461).

Because none of the gift can be enjoyed by the trust beneficiaries until the 10-year period has expired, it is a "future-interest" gift and, therefore, ineligible for the annual gift tax exclusion. Although that means the entire amount is taxable, it will qualify for Wax's lifetime gift tax exclusion. Since the present value of the gift – $426,539 – is less than the gift tax exclusion equivalent amount of $1,000,000 (in 2003), Wax will use up $426,539 of his available exclusion equivalent, and incur no out-of-pocket gift tax outlay. Therefore, he has transferred property worth $1,000,000 today at a discounted gift tax cost based on $426,539.

But if the property appreciates at 6 percent and produces income at 4 percent, it will be worth about $1.5 million at the end of 10 years, and none of it will be included in his estate if he survives that period. The estate tax savings may be as much as $750,000! Wax has removed almost $1.5 million from his estate with no out-of-pocket gift tax outlay.

In effect, a GRAT enables the grantor to create an estate freeze. The estate will either remain the same or decrease. A GRAT makes it possible for the grantor to retain an asset within the family unit while its value is "frozen" for death tax purposes. This technique is particularly appealing under economic conditions when asset values are depressed while at the same time interest rates are relatively low.

I often recommend that a wealthy surviving spouse or divorced individual consider a GRAT as a marital deduction substitute.

## ADDITIONAL REASONS TO CREATE A GRAT

There are many additional tax and non-tax benefits to GRATs:

A. The grantor pays transfer taxes at a "discount." But there are several levels of discount that may be obtained:

(1) Various discounts can, and should, be taken to assess the fair market value of the asset (including discounts for lack of marketability and lack of control, where appropriate). Valuation reduction techniques are particularly viable during times of economic slowdown, depressed business and real estate values and low interest rates. This valuation discount can be enhanced by putting property such as a limited interest in a family limited partnership or a minority interest in an LLC into the GRAT.

(2) As the grantor in a GRAT, the estate owner is making a current gift, but it is a gift of a "future interest" since the beneficiary has to wait a specified number of years to enjoy it. The grantor pays gift tax, not on what the trust beneficiary might actually receive, but on the value of the asset today – discounted for the "money value of the time" the beneficiary has to wait.

Since the actuarial value of the gift is measured by how long the recipient must wait, the longer the wait, the lower the value of the gift. In other words, the grantor can lower the gift tax value of the gift by stretching out the period during which he/she retains an interest. In the earlier examples, instead of gift taxes based on the $1,000,000 value of the asset today, because the remaindermen will not receive their interests until the end of 10 years, the gift tax value is lowered to less than $500,000—more than a 50 percent reduction.

By changing from a 10-year GRAT to a 20-year GRAT, the value of the remainder interest gift drops to about $32,000! Stated another way, the grantor can contribute even more – much, much more – without paying any additional out-of-pocket gift tax.

Compared to a current outright gift of the asset, GRATs are less expensive tax-wise and should be particularly appealing if an estate owner is concerned about gift and estate tax savings, and is willing to bet that he/she will outlive the term of the trust. The healthier the grantor is personally and the longer the family's history of longevity, the more likely he/she will survive the term of the trust and achieve the significant estate tax savings the GRAT offers.

B. The grantor can ensure succession. If certain assets (such as stock in a closely held corporation or land or a family compound) are to go to one child rather than another or, conversely, specifically not go to a former spouse, or creditor, a GRAT can help the grantor to assure that assets go to the beneficiary(ies) of his/her choosing. In most states, because a GRAT is an irrevocable trust, it is much less likely that the property will be lost if the grantor's estate is embroiled in a will contest, election against the will, or a creditor-imposed lawsuit on the estate.

C. Through a GRAT, the grantor can unify assets. If the grantor owns income-producing properties in more than one state and would like to unify the administration of those assets and save on probate costs, the GRAT will help avoid ancillary administration (probate of out-of-state property) and its consequent costs, delays, and aggravations.

D. GRATs are age neutral. There is practically no cut-off age after which a GRAT will no longer be mathematically feasible. These are "little to lose, lots to gain" tools that even people in their 80s may want to use. For instance, assuming a Section 7520 rate of 3.8 percent and a payout rate of 7 percent, an 80-year-old grantor can transfer $1,000,000 of assets to a child at a gift tax value of about $687,000 through a 5-year GRAT, and roughly $427,000 through a 10-year GRAT. The life expectancy is about 9 years at age 80, but if the grantor is healthy, it may pay to take the chance.

Staggered trust terms can be used if the grantor has a lower risk-taking propensity. For instance, the 80-year-old grantor can transfer some property into a 5-year GRAT and some property into a 10-year GRAT, or the octogenarian can create a series of 2-, 3-, 4-, 5-, 6-, 7-, 8-, 9-, and 10-year GRATs to hedge his or her risks.

GRATs are an almost no-lose situation. Let's look at a worst-case scenario. Suppose the grantor dies during the term of the trust and, as a consequence, some or all of the assets are included in his/her estate. Because all the tax credit used during lifetime to eliminate taxes on the gift is restored and any tax actually paid can be used as a dollar-for-dollar credit against the estate tax, in essence the grantor has "prepaid" his/her estate tax. The grantor practically can't lose.

A GRAT enables the grantor to leverage his/her gift tax credit. When compared to an outright gift, a GRAT uses up less of the grantor's gift tax credit. Stated another way, dollar for dollar, the grantor can gift more using the gift tax exclusion equivalent through a GRAT than through an outright gift. Since the GRAT combined with the gift tax credit typically will reduce the out-of-pocket cost to zero (or very close to zero), it is also psychologically superior to an outright gift (not to mention the fact that the pain of divestiture is eased by the ability to retain the annuity).

## COSTS AND DOWNSIDES

In all my articles, books, informal discussions and lectures, I always caution that no tool or technique should be viewed as a panacea or "one size fits all" solution. I also emphasize that no matter how exciting a concept may be, there are costs and downsides. In spite of the many advantages I've listed above, GRATs are no exception to my general rule.

Here are some of the major costs and downsides:

A. The grantor will encounter set-up and administration costs. These include legal fees, appraisal fees, property titling costs (in order to make the trust the legal owner of the assets), accounting and tax filing charges, as well as trustee fees.

B. The grantor will experience a loss of control. The grantor must be willing to give up the right to shift the income to someone else during the term of the trust. However, this income is roughly equivalent to what the grantor would have had if he/she had done nothing. Furthermore, some of the income the grantor receives can be given away or consumed.

A more important cost is that the grantor has also given up the right to dispose of the principal. Should the grantor no longer care for a named beneficiary, or does not want that beneficiary to receive as much as the grantor had originally intended, there is no way to change the amount or proportion – once the trust is funded.

C. The grantor will also experience a loss of opportunity. Since the GRAT is an irrevocable trust, once assets are placed into the trust, the grantor is precluded from taking other planning measures with the property in the trust.

D. There is the potential for estate tax inclusion. If the grantor dies during the term of the trust, the executor may be liable for the tax on the includible assets. But the estate may not have the cash to pay this tax.

The solution is to make a reasonable projection of the grantor's life expectancy, based on mortality tables, personal (and family) health history, as well as his/her habits, occupation, and avocations. Then the grantor can create one or more trusts that can be expected to expire before he or she dies. The grantor can also include a provision that returns all the assets in the GRAT to his/her estate (rather than go to the specified beneficiaries) if he/she dies during the term of the trust. This reversion to the grantor's estate, and from there to his/her surviving spouse (either through a will or through a marital deduction trust) can alleviate or eliminate the problem – provided it is set up so the marital deduction will eliminate the federal estate tax on the includible assets.

Life insurance owned by a third-party, such as an irrevocable trust, can be used to ensure death tax savings. This bullet-proofing of estate tax savings is described in more detail below.

E. Assets in the trusts may generate insufficient income. To produce the high annuity payouts – hence, reduce the value of the remainder interest to within the gift tax exclusion equivalent – the assets placed in a GRAT must generate commensurably high income for the term of the trust. Most publicly held stocks are an inappropriate investment for a GRAT because of their relatively low current yield; and few closely held stocks pay dividends high enough to meet the required annuity payment.

S corporation stock may be an appropriate GRAT asset, if it can be readily and cost-effectively valued and if it produces income equal to or above the required annuity payment. A limited partnership (an LP or FLP) or a limited liability company (LLC) that generates considerable income might be a better choice.

To the extent that the investment does not pay income equal to or exceeding the required annuity payout, trust assets will have to be sold to make up the shortfall. If this is necessary, the trust remainderman (e.g., the grantor's child or other beneficiary) may never receive the intended wealth at the end, and the grantor will not achieve his/her desired estate-tax-savings objectives.

Worse yet, if dividend income is insufficient to make the required payments, to whom can the GRAT sell the closely held stock to raise the cash? At what price could a minority interest be sold? What would the costs (psychological and otherwise) be to shareholders and the corporation – if the GRAT must sell the stock to someone outside the family unit? What if the buyer is not a family member who, as a result of purchasing the stock from the trust, now becomes a controlling shareholder?

F. Trust assets may experience insufficient growth. If the combined earnings and appreciation are less than the federal discount (Section 7520) rate assumed in computing a GRAT, any anticipated estate tax savings will be lost and reverse leveraging will occur.

G. There may be valuation problems and expenses in connection with a GRAT. Ideally, the best assets to place into a GRAT are those that produce unusually high income, have a strong potential for significant growth, and are easily and inexpensively valued. Although inexpensive software packages are now available for business valuation purposes, independent, professional appraisals will still be required in most cases. Furthermore, there is also a high probability that the IRS will audit any valuation dealing with a closely-held business. (The GRAT typically needs to be valued only at its inception.)

## INCOME TAX IMPLICATIONS

A. Since the grantor retains the right to trust income during the term specified in the trust, he or she will be taxed on all accounting income of the trust. The grantor is not taxed on capital gains since they are added to the trust principal and will eventually go to the remainderman beneficiary. Once the term expires, the trust beneficiary will be taxed on trust income, assuming it is paid out. Otherwise, it will be taxable to the trust.

B. It is not uncommon for planners and advisors to advocate that as much income as possible should be taxable to the grantor rather than to the trust or its beneficiary. On the surface, this will seem counter-intuitive (especially to the grantor) but, in reality, each tax payment the grantor makes will benefit the trust beneficiary – without having the payment be subject to gift tax. Remember, the gift, estate, and GST tax rates start at 37 percent and proceed (to over 40 percent) quite rapidly. Under current law, the transfer tax rates are generally higher than the income tax rates (for individuals). This is why planners and advisors often try to have the grantor pay as much income tax as possible in order to create what are essentially gift-tax-free gifts from the grantor to the trust beneficiaries.

## GIFT TAX IMPLICATIONS

The gift to the remainderman at the time the trust is funded (i.e., the date the grantor puts assets into the GRAT) is a future interest gift. This means it will not qualify for the annual gift tax exclusion. The value of the gift is calculated by subtracting the value of the grantor's retained interest from the entire value of the assets placed in the trust.

If the grantor survives the specified trust term, the trust property is paid to, or held in trust for, the remaindermen beneficiaries – and there will be no second gift tax (regardless of the value of the remaining trust assets). This is because the gift to the trust beneficiaries was "complete" (albeit of a future interest nature) when the grantor established the GRAT and contributed cash or other assets to it.

## PROBLEMS IF PROPERTY SUBJECT TO INDEBTEDNESS IS TRANSFERRED TO GRAT

Generally, it is not advisable to use mortgaged property as a gift to a GRAT. The cash flow used by the trust to satisfy a loan against the property could be considered use of trust income for the grantor's benefit. Although this is not a major problem per se, since the grantor is to be taxed on trust income; however, if and when the grantor makes payments on the loan or indebtedness, the IRS could consider such payments as additions to the trust – an action that is impermissible in a GRAT. In this case, the grantor will have violated the trust requirements – with potentially disastrous gift tax consequences. The IRS could hold that the entire amount the grantor puts into the trust is a taxable gift.

Perhaps an equally serious problem is that additional payments on the mortgage may be viewed as taxable gifts. If the value of the original taxable gift is based on the net value of the property (that is, gross value less encumbrances), the IRS may treat each mortgage payment the grantor makes as an additional non-excludable gift.

## "ROLLING GRATs"

Rolling GRATs are short-term GRATs. The idea is that, rather than increasing the risk of the grantor's dying during the term of the GRAT, shortening the term decreases the risk of estate tax inclusion. This technique works best when the growth (aside from any income) in the funding property is expected to significantly outpace the federal discount (Section 7520) rate during the short term specified. Although the taxable gift is higher for short-term GRATs (because the beneficiary has to wait a shorter period of time to get the assets), the amount that can be shifted to a child or other beneficiary at relatively low risk and little cost (of higher gift tax) may be significant enough to warrant such an approach.

The younger the grantor, the more wealth he or she can shift wealth to the trust beneficiaries. (The annuity is worth more for younger than older people because of the requirement that mortality must be considered even in a term-certain GRAT.) If the grantor then takes the annuity he or she receives and continues to create a series of short-term GRATs, the probability of death during the term is reduced. Therefore, the value of the retained interest increases, lowering the value and the tax impact of the taxable gift.

## "BULLET-PROOF" THE ESTATE TAX SAVINGS

Life insurance is the most certain way to eliminate (or more, accurately compensate for) the risk that the grantor's family will have to pay federal estate tax on the GRAT assets if the grantor dies during the trust term. The grantor can "bullet-proof" the tax savings potential by gifting a small amount of cash each year to the intended beneficiaries who then purchase term insurance on the grantor's life in an amount equal to the potential estate tax savings. This insurance can also be owned and held by an irrevocable life insurance trust created on behalf of the beneficiaries – who may or may not be the same individuals who will benefit under the GRAT.