THE NAUTILUS GROUP®

Grantor Retained Annuity Trust

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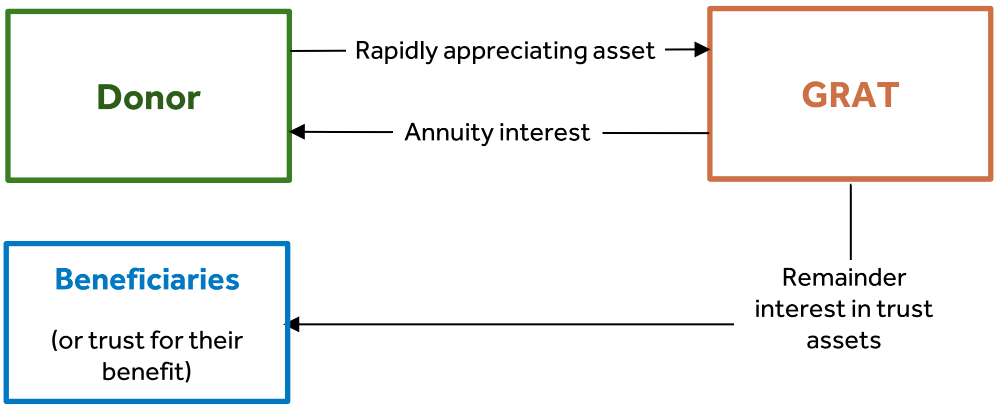
A grantor retained annuity trust (GRAT) is an estate planning technique that allows an individual to transfer assets outside of their taxable estate at a reduced gift tax cost while retaining an income stream for a term of years or for the individual's lifetime. GRATs are generally most effective when used to remove highly appreciating property from a donor's estate. If the transferred asset produces a return greater than the growth rate assumed by the IRS, the excess growth will pass to the remainder beneficiaries free of gift tax.

Implementing a GRAT

To implement a GRAT, the donor transfers property to a specially designed irrevocable trust. Generally, highly appreciating assets and income producing assets are ideal for GRAT funding. The donor retains an annuity interest for either a specified term of years, the donor's lifetime, or the shorter of the two (the "annuity term"). At the end of the annuity term, the property either remains in trust for the donor's beneficiaries or is distributed outright to the donor's beneficiaries.



The expected value of the beneficiaries' remainder interest in the property at the end of the annuity term is a taxable gift upon GRAT funding; however, the donor may be able to utilize his/her lifetime exclusion amount (in 2026, $15 million) to offset any gift tax liability. The value of the remainder interest is determined by an actuarial calculation that accounts for the present value of the donor's annuity interest and the expected growth of trust assets using the rate as established in Internal Revenue Code (IRC) §7520. Thus, where assets used to fund a GRAT appreciate greater than the assumed Section 7520 rate, the excess appreciation passes to the donor's beneficiaries free of gift tax. In the event the donor dies during the annuity term, a portion of the GRAT's value will be included in the donor's estate.

"Zeroed Out" GRAT

Where a donor wishes to create little or no gift tax liability upon creation of a GRAT, the donor can structure annuity payments so that his/her retained interest equals the value of trust assets, thereby "zeroing out" the remainder interest (and resulting gift tax). This may be accomplished by setting the annuity pay-out high enough, based on the Section 7520 rate and length of the annuity term, so that actuarily nothing would remain in the trust at the end of the term. This technique is successful when the transferred asset grows faster than the Section 7520 rate, allowing the remainder to pass free of gift tax.

Rolling GRATs

Rolling GRATs are a series of short-term GRATs that are established one right after another, typically in two-year terms. The donor would place annuity payments received in each of the two years into new GRATs. At the end of each GRAT term, remaining assets would pass to remainder beneficiaries or a trust for their benefit. Using rolling GRATs minimizes the risk of the donor's death during the GRAT period.

GRAT requirements

A GRAT must be structured so that the value of the donor's retained interest can be subtracted from the value of trust assets in determining the gift upon formation. To do so, the irrevocable trust must be designed to comply with the GRAT requirements as set out in Treasury Regulation §25.2702-3(b).

- The annuity interest retained by the donor must be a "qualified interest," defined as an irrevocable right to receive a fixed amount annually.
- The annuity term must be fixed for the donor's life, a term of years, or the shorter of the two.
- The annuity interest must be paid annually (in cash or in kind) based on the trust anniversary date or the trust tax year. If based on the trust anniversary date, the annuity must be paid within 105 days of the anniversary date. If based on the trust's tax year, the annuity must be paid by the due date of the trust's tax return, without extensions.
- The fixed annuity amount can be expressed as either a stated dollar amount or a fixed fraction or percentage of the initial fair market value of the trust property, as finally determined for gift tax purposes. If the annuity amount is stated as a fixed fraction or percentage, the trust should contain provisions requiring an adjustment of the annuity payment for an incorrect determination of the fair market value of trust assets. Additionally, the stated dollar amount or percentage does not have to be the same each year, but it cannot exceed 120% of the amount payable in the previous year.
- Regardless of trust income, the trust must make required annuity payments. If income is insufficient, the trustee must use principal to fund the payments. The trust cannot use a promissory note or other debt instrument to satisfy required annuity payments.
- The trust must require proration for short years.
- No payments from the trust may be paid to anyone other than the holder of the annuity interest (the donor).
- The trust must prohibit additional contributions to the trust.
- The trust agreement also must prohibit commutation (or prepayment) of the annuity interest.

Tax considerations

Income tax

The donor's annuity interest in the trust generally results in the trust being deemed a "grantor trust" during the annuity term. This means the donor must include the trust income, gain, loss, deductions, and credits in his/her income tax return. If assets will remain in trust for beneficiaries after the annuity term, the trust can be structured to continue its grantor trust status, if so desired.

After the annuity term, the donor's beneficiaries (or the trust) receive a carried-over basis in the assets. This means that the beneficiary's/trust's basis will equal the donor's basis at the time he/she contributed assets to the GRAT.

Gift tax

The value of the taxable gift that results from implementing a GRAT equals the remainder interest and is determined by deducting the value of the donor's retained annuity interest from the fair market value of trust assets. The value of the remainder interest depends on the length of the annuity term, the value of the annuity interest payable to the donor, and the Section 7520 rate. Generally, gift taxes can be reduced by increasing the annuity interest and annuity term.

If gift tax will be owed upon GRAT funding, the donor can utilize his/her lifetime exclusion amount (in 2026, $15 million) to offset gift tax liability. Since the remainder interest is not a present interest gift, the donor's annual gift tax exclusion (in 2026, $19,000 per donee) cannot be used to offset gift tax liability.

Estate tax

If the donor dies during the annuity term, a portion of the value of the GRAT will be included in his/her estate. The portion includible in the donor's estate is generally the portion of trust assets necessary to produce the remaining required annuity payment, based on the Section 7520 rate applicable at the donor's death. For this reason, a term shorter than the donor's life expectancy is common.

Generation skipping transfer tax

Generation skipping transfer (GST) tax exemption cannot be allocated to transfers during any estate tax inclusion period (ETIP). The annuity term of a GRAT is an ETIP, meaning the donor cannot allocate GST tax exemption to the trust until the earlier of the end of the annuity term or upon the donor's death. For this reason, GRAT planning is typically only used to benefit a child or other non-skip beneficiary.

Advantages of a GRAT

- When the Section 7520 rate is low, a GRAT becomes an attractive asset shifting vehicle.
- A zeroed-out GRAT can enable an individual with no remaining lifetime exclusion to reduce potential exposure to estate tax liability.
- Because the requirements are provided in IRS Treasury Regulations, a GRAT may have less audit risk than other asset shifting techniques.
- Utilizing a valuation formula within the GRAT instrument can minimize the risk of unexpected gift tax consequences should the Internal Revenue Service challenge the valuation.

Disadvantages of a GRAT

- Once assets are transferred to a GRAT, the donor irrevocably loses control over trust assets and only retains access to transferred assets through his/her annuity interest.
- GST tax exemption cannot be allocated to GRAT assets until the end of the annuity term or upon the donor's death.
- If a donor dies during the annuity term, a portion of the value of the GRAT will be included in his/her estate.

As a result of H.R.1 of the 119th Congress (commonly known as the One Big Beautiful Bill Act), the estate, gift, and generation skipping tax exemptions amounts enacted under the Tax Cuts and Jobs Act of 2017 were made permanent. Effective January 1, 2026, the exemption amount will be $15 million per person ($30 million for a married couple), with annual adjustments for inflation. For assets transfers in excess of the applicable exemption amount and otherwise subject to such taxes, the highest applicable federal tax rate remains at 40%. In addition, under different rates, rules, and exemption amounts (if any), there may be state and local estate, inheritance, or gift taxes that apply in your circumstances. Please consult your own tax or legal advisor for advice pertaining to your specific situation. This tax-related discussion reflects an understanding of generally applicable rules and was prepared to assist in the promotion or marketing of the transactions or matters addressed. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer. New York Life Insurance Company, its agents and employees may not provide legal, tax or accounting advice. These materials are prepared by The Nautilus Group®, a service of New York Life Insurance Company, and are made available to all Nautilus Group member agents, and as a courtesy, to select agents of New York Life Insurance Company.
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