FERRIS FINANCIAL, LLC

Helping You Plan, Protect & Prosper

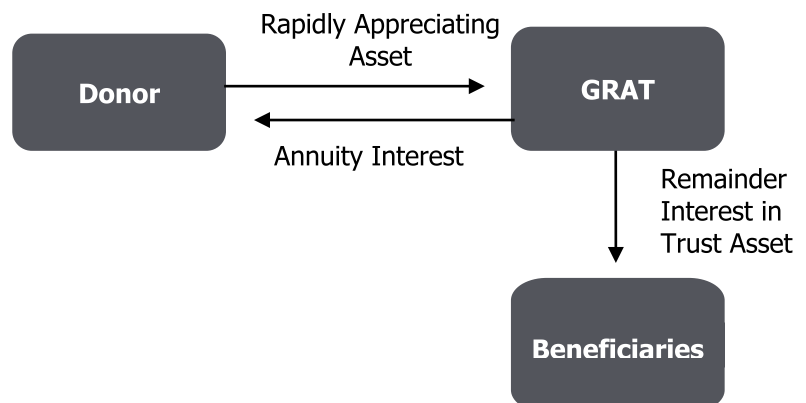
Overview

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. GRATs are generally most effective when used to remove highly appreciating property from a donor's estate. If the transferred asset produces a return in excess of the growth rate assumed by the IRS, the growth in excess of that assumed rate will pass to the remainder beneficiaries free of gift tax.

Description & Operation

To implement a GRAT, the donor transfers property to a specially designed irrevocable trust. The donor retains an annuity interest for a specified term of years (the annuity term). At the end of the annuity term, the property either remains in trust for the donor's beneficiaries (usually the donor's children), or is distributed to the donor's beneficiaries outright. The expected value of the beneficiary's remainder interest in the property at the end of the annuity term is a taxable gift at the inception of the GRAT.

1. Donor transfers an asset that is expected to grow more rapidly than the assumed IRC Section 7520 rate.
2. Donor receives annuity payments from the trust for a specified term.
3. At the end of the annuity term, trust assets can remain in trust for the Donor's beneficiaries, or can be distributed to the beneficiaries outright.



Generally, the irrevocable trust must be designed to comply with the GRAT requirements as set out in Treas. Reg. Sec. 25.2702-3(b):

- The annuity interest retained by the donor must be a "qualified annuity interest," defined as an irrevocable right to receive a fixed amount.
- The annuity interest must be paid annually based on the trust anniversary date or the trust tax year.
- The annuity term must be fixed for the donor's life, a term of years, or the shorter of the two.
- 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 cannot exceed 120% of the amount payable in the previous year.
- The trust cannot use a promissory note or other debt instrument to satisfy required annuity payments.
- The trust must require proration for short years, excluding the first year.
- No payments from the trust may be paid to anyone other than the holder of the annuity term interest.
- The trust must prohibit additional contributions to the trust.
- The trust agreement also must prohibit commutation or prepayment of the annuity term holder's interest.

Tax Implications

Income Tax Considerations

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. The trust can be structured to continue its grantor trust status after the annuity term ends. Grantor trust status in effect allows the donor to make additional "gifts" to the trust equal to the trust's income tax liability, without incurring additional gift tax. In addition, grantor trust status prevents transactions between the donor and the trust (i.e., the transfer of property and receipt of annuity payments) from being a taxable event.

Gift and Estate Tax Considerations

Gift Tax: The value of the taxable gift that results from implementing a GRAT is determined by computing the remainder interest of the transferred asset using actuarial tables issued pursuant to IRC Section 7520. The value of the remainder interest is the value of the property transferred, minus the actuarial value of the donor's retained annuity interest. The gift value 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.

A donor may desire to minimize gift tax by structuring annuity payments such that the value of the remainder interest will equal zero. 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 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.

Estate Tax: If the donor dies during the trust term, a portion of trust assets could be included in the donor's estate. The portion of trust assets includible in the donor's estate will be the portion of trust assets necessary to produce the remaining required annuity payment. For this reason, a term shorter than the donor's life expectancy is common. To address the possibility that the donor may die during the trust term, the trust agreement can contain a partial contingent reversion clause that will return the portion of trust assets includible in the donor's estate to the donor's estate if the donor dies during the annuity term. The reversion can provide the donor's estate with assets to pay the estate tax. Alternatively, the trust agreement can require that the trustee reimburse the donor's estate for estate taxes paid on any part of the trust included in the donor's taxable estate or the trust agreement can contain a clause providing that any amount included in the donor's estate passes to the donor's spouse in a manner that qualifies for the marital deduction.

Insights and Caveats

Rolling GRAT

Rolling GRATs are a series of short-term GRATs that are established one right after another, typically in 2-year terms. The donor would place annuity payments received in each of the two years into two new GRATs. At the end of each GRAT term, remaining assets would pass to remainder beneficiaries or a trust for their benefit. Use of rolling GRATs provides the additional advantage of minimizing the risk of the donor's death during the GRAT period. Through a series of short-term GRATs in high-yield years, appreciation is passed to the remainder beneficiaries at the termination of the GRAT.

Multigenerational Planning

GST 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 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.

S Corporation Stock

A GRAT can hold S Corporation stock during the annuity term if the GRAT is a grantor trust. Upon termination of the annuity term, the GRAT becomes an ineligible shareholder, causing the corporation to lose its S Corporation status, unless the trust remains a grantor trust or qualifies as another type of trust that can hold S Corporation stock.

Ferris Financial, LLC

Matthew Ferris*, MBA

150 E. Mound Street, Suite 301, Columbus, OH 43215
Phone: (614)227-7090
msferris@ferris-financial.com

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