Scarlet Oak Financial Services
Faye Sykes, CLTC, NSSA
CEO & Independent Advisor
1117 Perimeter Center West
Suite W-212
Atlanta, GA 30338
800-871-1219
fsykes@scarletoakfs.com
www.scarletoakfs.com

Understanding Grantor Retained Annuity Trust (GRAT)

A GRAT is generally used to transfer rapidly appreciating or high income-producing property to heirs with the main goal of transferring, free of federal gift tax, a portion of any appreciation in (or income earned by) the trust property during the annuity period.

A grantor retained annuity trust (GRAT) is an irrevocable trust into which you make a one-time transfer of property, and from which you receive a fixed amount annually for a specified number of years (the annuity period). At the end of the annuity period, the payments to you stop, and any property remaining in the trust passes to the persons you've named in the trust document as the remainder beneficiaries (e.g., your children), or the property can remain in trust for their benefit.

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Tip: *With a GRAT, you generally receive a fixed dollar amount that does not change even if the value of the trust property increases or decreases. Alternatively, you may retain the right to receive a fixed percentage of the trust property determined annually. This is known as a grantor retained unitrust (GRUT). A GRUT provides more income, but less tax savings, than a GRAT.*

How a GRAT works

Because a GRAT is an irrevocable trust, when you transfer property to the GRAT, you're making a taxable gift to the remainder beneficiaries. The value of the gift is discounted because of your retained interest. The amount of the discount is calculated using IRS valuation tables that assume the property in the trust will realize a certain rate of return during the annuity period. This assumed rate of return is known as the Section 7520 rate, discount rate, or hurdle rate. If the property in the trust grows more than the IRS assumes it will, the excess growth will pass to the remainder beneficiaries gift tax free.

For example, say you transfer your high yield investment portfolio worth $1 million to a GRAT that will pay you $117,000 at the end of each year for 10 years. Also say that the current Section 7520 rate is 3.0%. According to the IRS tables, your retained interest is valued at $998,033, and the taxable gift to the remainder beneficiaries is valued at $1,967. You pay federal gift tax on $1,967 or offset this amount with your gift and estate tax applicable exclusion, to the extent it has not already been used.

If the investment portfolio actually earns a 3.0% annual return over the 10-year term, about $1,967 will be left in the trust to distribute to the remainder beneficiaries. If, however, the investment portfolio actually earns a 5.0% annual return, about $157,281 will pass to the remainder beneficiaries (but the taxable gift will have been only $1,967). And, if the investment portfolio actually earns a 10.0% annual return, about $729,064 will pass to the remainder beneficiaries (but the taxable gift will have been only $1,967).

Caution: *Because the transfer to the remainder beneficiaries is not a present interest gift, it does not qualify for the annual gift tax exclusion.*

You may fail to outlive the annuity term

If you die during the GRAT term, all of the property in the trust will be included in your gross estate for federal estate tax purposes. The advantages of the GRAT will be lost, and you will have incurred the costs of creating and maintaining the GRAT for nothing.

Tip: *The remainder beneficiaries may want to buy life insurance on your life to cover any taxes that may result from the inclusion of the GRAT property in your gross estate.*

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 will be achieved (the trust may even be depleted), defeating the purpose of the GRAT. This outcome puts the grantor

Zeroed-out GRAT

A GRAT can be structured so that the value of the retained interest is equal to the value of the property transferred to the trust. Hence, the remainder interest, and the taxable gift, is valued at zero. This is known as a zeroed-out GRAT. A zeroed-out GRAT may be an attractive option if you've already used up your federal gift and estate tax applicable exclusion and you don't want to pay federal gift tax on the transfer

Appropriate property for a GRAT:

- *Rapidly appreciating property*
- *Property expected to outperform the Section 7520 rate*
- *High growth or high yield investment portfolios*
- *Commercial real estate*
- *Closely held stock*
- *FLP interests*

in the same position he or she would have been in had the GRAT not been created; however, the costs of creating and maintaining the GRAT will have been wasted.

Tip: *The Section 7520 rate is generally based on current risk-free interest rates. Thus, a GRAT can be especially attractive in a low interest rate environment.*

GRAT generally not appropriate for generation-skipping transfers

The federal generation-skipping transfer tax (GSTT) (and perhaps state GSTT as well) will apply to transfers of property made to a GRAT if some or all of the remainder beneficiaries are two or more generations below the grantor (these are known as skip persons). However, the transfer does not actually occur until the grantor's retained interest terminates. Thus, the grantor cannot allocate his or her GSTT exemption to the transfer until the end of his or her retained interest (or estate tax inclusion) period (this is known as the estate tax inclusion period or "ETIP" rule). Allocating the GSTT exemption when the trust property has already appreciated fails to leverage the exemption. Therefore, a GRAT may not be an appropriate device for making transfers to skip persons.

Tip: *A grantor may be able to circumvent these generation-skipping transfer limitations using sophisticated estate planning techniques. An experienced estate planning attorney should be consulted.*

Remainder beneficiaries do not receive a step-up in basis

Unlike property received because of the death of the transferor, property transferred to the remainder beneficiaries does not receive a step-up in basis.

Tip: *This situation may be averted if the grantor buys the trust property at the end of the retained interest period. The remainder beneficiaries get the cash instead, and the property will receive the step-up in basis at the grantor's death.*

GRAT is considered a grantor trust for income tax purposes

For income tax purposes, a GRAT should be a grantor trust. Being classified as a grantor trust means that all items of income and deductions flow through to the grantor. This is the case even if all of the income earned by the trust property is not distributed to the grantor. The grantor should have other property available to meet this liability.

To schedule an appointment with Faye Sykes, click here .

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