Grantor Retained Annuity Trust

With the ever-changing landscape of taxes, it is growing increasingly difficult to understand how legislation affects clients and could possibly impact their financial future. As a leader in the financial services industry for over 30 years, we get it. That's why HD Vest Financial Services® is constantly seeking ways to share the latest knowledge we acquire with you. We've created the Taxes & Investments: Timely and Timeless Strategies Series to share timely information and provide our Advisors and their clients with practical information and ideas they can build on.

What is a Grantor Retained Annuity Trust?

A Grantor Retained Annuity Trust (GRAT) is a complex financial tool used to transfer wealth from an individual (grantor) to a beneficiary(ies) while retaining an income stream from those assets. A GRAT works by the grantor irrevocably gifting assets with high appreciation potential to a trust that will then pay the grantor an income stream for a set number of years, or the shorter of the term of years, or life. The income is a fixed amount set at the inception of the trust and paid out to the grantor at least annually. At the death of the grantor, the assets revert to the listed non-charitable beneficiary(ies) through the terms of the trust document[1].

Who Should Consider a GRAT?

1. Taxpayers who own assets that are likely to appreciate over time and that produce income that exceeds the IRS 7520 discount rate[2].
2. Family business owners who would like to transfer their business to a child with minimum estate and gift tax. This strategy also allows the owners to retain control of the business until they die without adding the value back into their estate[3].
3. Taxpayers who own income producing property in more than one state, and unification and probate savings are desired.
4. Individuals who own high-income producing property that would like some estate tax savings.
5. Married couples who have an estate valued at more than the couple's combined unified credit equivalent amount and the assets in the estate have a high growth potential.
6. If an individual wants protection from will contests, public scrutiny of their assets, or an election against the will if the grantor survives the trust term.
7. Taxpayers who anticipate selling non-income producing property at a premium in the future. A GRAT allows an individual to lock in the lower current value for gift tax purposes at a minimal gift tax cost. The value of such property is often less than a proportional share of its fair market value due to the minority and marketability discounts available[1].

How Does it Work?

To utilize the GRAT strategy, the grantor makes a gift of assets to the GRAT. This gift is irrevocable, meaning it cannot be changed or revoked, and the trustee is given sole control of the trust. The amount of the gift to the trust may be discounted depending on the nature of the property gifted[1].

The grantor would then receive an annuity income stream from the trust for a certain number of years. The annuity may be paid in a fixed dollar amount or as a specific percentage of the initial value of the trust's assets. The income stream amount is based on the IRS 7520 discount rate[2]. If income from the GRAT each year is not enough to pay the annuity, trust principal must be used to make the payments. When the annuity period ends, the assets in the trust, including all of the appreciation, go to the beneficiaries[3].

If the grantor survives the GRAT's annuity term, none of the assets in the trust will be subject to federal estate tax upon his or her death[3].

Considerations

There are several things to consider before implementing this estate planning strategy. As this is a more complex strategy that will require legal counsel, there will be attorney fees and other transaction costs associated with a GRAT. Another point to consider is this is an irrevocable trust. Once the assets are placed into the trust they cannot be removed. Thirdly, if the grantor dies during the GRAT term, the value of the remainder interest in the trust is included in the grantor's taxable estate[3]. Finally, the property will keep the original owner's basis, so there is not a step up in basis upon the original owner's death[3].

A GRAT can play an integral part in an individual's estate planning strategy as it can provide a way to minimize estate and gift taxes paid upon the death of the grantor. A GRAT is a complex financial planning tool, and because of its complex nature, it is important to bring in a team of highly qualified professionals to manage the strategy. The best place to start is with your HD Vest Financial Advisor who can help with both the tax and investment strategies involved in the plan as well as refer a trusted attorney if you do not already have one.

Sources:
[1]Leimberg, Stephan R. Tools & Techniques of Estate Planning. 15th ed. Erlanger, KY: National Underwriter, 2011. Print.
[2]IRS Section 7520 Rates- http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Section-7520-Interest-Rates
[3]IRS Bulletin No. 2011-50- http://www.irs.gov/pub/irs-irbs/irb11-50.pdf