

Grantor Retained Annuity Trusts (GRATs)

Memorandum

If you have a high yield asset which you expect to appreciate in value in the future, consider the strategy of establishing a GRAT described in this memorandum. A GRAT allows you to retain an income interest, and to make a gift to a younger generation free of federal gift or estate taxes. The current low interest rate environment makes GRATs particularly attractive.

Grantor Retained Annuity Trusts (GRATs)

A Grantor Retained Annuity Trust (GRAT) can be used to accomplish substantial wealth transfers from a senior generation to a younger generation with little or no gift taxes. Moreover, the senior generation establishing the GRAT (referred to as the "grantor") can retain the right to receive income from the property (an annuity interest) for the grantor's life or a specified term of years. Because the grantor retains a life income interest, the gift is the remainder interest in the GRAT, which has a reduced value (less than the assets transferred to the GRAT) for gift tax purposes. Upon termination of the GRAT, the assets are distributed to the younger generation free of tax, including any appreciation in the value of the GRAT assets. GRATs are specifically sanctioned by Section 2702 of the Internal Revenue Code, provided certain requirements are met.

1. Description

A grantor establishes a GRAT by transferring assets to an irrevocable trust. The grantor retains an annuity or income interest, usually for a specified number of years, payable at least annually. The income interest can be expressed as **(1)** a fixed dollar amount, **(2)** a fixed percentage of the trust's *initial value*, or **(3)** as a so-called unitrust interest being a fixed percentage of *annual value* of the trust.

The transfer of assets to the GRAT is a taxable gift. The value of the annuity or income interest is determined by reference to IRS actuarial tables issued under Code Section 7520. For gift tax purposes, the value of the taxable gift is the value of the remainder interest in trust; it is calculated by taking the entire value of the assets transferred to the GRAT *reduced by* the actuarial value of the annuity/income interest retained by the grantor. The amount of the taxable gift may be reduced to zero (or close to zero) if the value (or rate) of the annuity is high enough. "Zeroing out" a GRAT transaction means that the term and size of the annuity payouts are arranged so that there is little or no taxable gift upon creation of the GRAT.

The amount of any taxable gift that arises upon establishment of the GRAT will be sheltered by the grantor's \$1 million lifetime federal gift tax exemption (but may be subject to state gift tax). Accordingly, the taxable gift value of the GRAT (the value of the remainder interest) is generally structured not to exceed \$1 million.

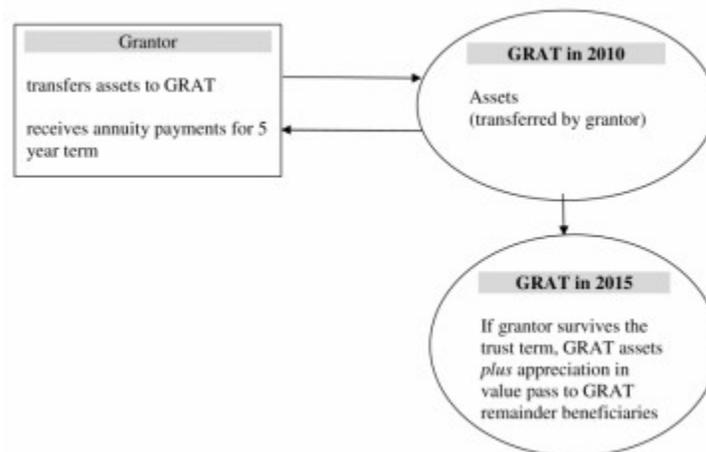
2. Tax Planning Objectives and Advantages

- GRATs can be effective to achieve an "estate freeze," so that any future appreciation in the assets inure to the benefit of the remainder beneficiary (*i.e.*, the younger generation).
- The grantor can retain most or all of the income generated by the property transferred for the term of the GRAT.
- If the grantor outlives the term of the GRAT, the value of the GRAT assets (and future appreciation) is removed from the grantor's estate and passes to the younger generation free of federal estate or gift taxes.

3. Disadvantages

- The trust must be irrevocable, and during the term of the GRAT the trust assets are no longer the personal assets of the grantor or of the remainder beneficiaries. Neither the grantor nor the remainder beneficiaries can pledge or sell the trust assets, and neither can reflect the trust assets on their personal financial statements.
- The grantor must outlive the term of the annuity/income interest to achieve any estate tax savings. If the grantor dies during the GRAT term, the trust assets are includible in his estate.
- Because the GRAT is treated as a "grantor trust" for income tax purposes, the grantor is taxed on all trust income, even if it exceeds the amount paid as an annuity interest.
- To achieve a successful wealth transfer to the younger generation, the "total return" of the GRAT must exceed the published IRS Code Section 7520 rate. The "total return" is the sum of all income generated by the trust, *plus* the appreciation in trust assets.
- Because the GRAT must (i) generate enough income to pay the annuity interest and (ii) the annuity interest must exceed the assumed Section 7520 rate of return to obtain gift tax savings, in general only high-yield assets that produce significant cash flow are suitable to fund a GRAT.
- Legal, administrative and appraisal fees will be incurred to establish the GRAT. The trust assets distributed to the remainder beneficiaries will have a carryover basis.

4. [Diagram of a GRAT](#)



5. Example of Potential Tax Savings

Below is an example of how a GRAT works to achieve the transfer of wealth to a younger generation with reduced gift tax consequences based on the Section 7520 rate of 3.2% in effect for March 2010 (the rates are republished monthly):

Facts:

A Grantor, age 60, wishes to give \$1,000,000 of high yielding corporate bonds to Child. Grantor establishes a GRAT and transfers the \$1,000,000 of bonds paying 8 percent interest. The GRAT directs the trustee to pay to Grantor \$60,000 per year for 10 years or until the Grantor's death, whichever occurs earlier. The GRAT ends upon expiration of the 10-year annuity, and the trustee distributes the bonds outright to Child.

Results:

- For gift tax purposes, the value of the Grantor's annuity is worth \$417,006; the gift tax value of the Child's remainder interest is \$528,994.
- No federal gift tax is owed because the gift of the Child's remainder interest is entirely shielded by the Grantor's \$1 million lifetime federal gift tax exemption. The Grantor's exemption equivalent available at death will be reduced by the amount of the gift.
- Yet after 10 years, the Child receives the \$1,000,000 of corporate bonds *plus* \$178,456 of

compounded interest (the amount by which the interest yield on the bonds exceeds the annuity payout over the 10-year term of the annuity).

- The results might be improved if the bonds were held in a family limited partnership and valuation discounts taken upon the initial transfer to the GRAT.

Federal

Tax

Advice

Requirements

The IRS has issued requirements governing the rendering of written tax advice concerning federal tax issues. In compliance with those requirements, the advice concerning federal tax matters set forth herein is not intended or written to be used, and cannot be used (1) for the purpose of avoiding penalties under federal tax law, (2) the advice was written to support the promotion or marketing of the matters or transactions addressed herein, and (3) you should seek advice based on your particular circumstances from an independent tax advisor.

If you have any questions about GRATs, please feel free to contact [Chris Was](#) at cwas@millermartin.com or any other member of Miller & Martin's [Estate Planning & Administration](#) Practice Group.

The opinions expressed in this bulletin are intended for general guidance only. They are not intended as recommendations for specific situations. As always, readers should consult a qualified attorney for specific legal guidance. Should you need assistance from a Miller & Martin attorney, please call 1-800-275-7303.

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