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Grantor Retained Annuity Trusts: Heads You Win, Tails You Tie

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Grantor retained annuity trusts, or "GRATs", are trusts used to make future gifts of appreciating property to family and friends on a virtually tax-free basis. The current historically low interest rates make GRATs more attractive than ever.

GRATs are irrevocable trusts where assets are transferred. In exchange for the assets, the transferor gets an annuity that pays back a fixed amount each year. The transferor sets the annuity amount and the length of time (or term) of the trust.

The transferor pays a gift tax on the current fair market value of the trust assets, minus the value of the grantor's retained annuity interest. If the GRAT is structured so that the value of the retained annuity is equal to the value of the property transferred, there is no gift tax consequence. GRATs structured this way are called "zeroed out" GRATs.

When zeroing out a GRAT, the annuity amount is calculated using a rate set by the Internal Revenue Service (called the section 7520 rate) for the month of the transfer. The section 7520 rate or "hurdle rate" is the assumed rate of return for the assets. For October, 2010, the hurdle rate was 2.0%, which tied the lowest rate in history.

The annuity amount is paid to the transferor during the term of the GRAT, and any property remaining in the trust at the end of the GRAT term passes to the beneficiaries gift tax-free. If the GRAT assets produce a return in excess of the hurdle rate, the increase in value is passed to the beneficiaries free of gift tax. Therefore, assets likely to appreciate at a rate higher than the hurdle rate are ideal for use with GRATs.

With interest rates at exceptionally low levels, GRATs are very attractive. Many people feel confident that their assets will grow at a rate that exceeds the hurdle rate. However, there is a catch. If the transferor dies during the GRAT term, the value of the remainder interest in the trust is included in the transferor's taxable estate. To minimize the risk that the assets will be taxed in the transferor's estate, multiple short-term GRATs are often used.

When structured correctly, GRATs offer little risk. If the assets in the GRAT do not appreciate at a rate that exceeds the hurdle rate, the GRAT fails, but the transferor receives back all of the assets transferred to the GRAT in the form of annuity payments. If the transferor does not survive the annuity term, the GRAT fails at least in part, but again, the transferor (or the transferor's estate) is no worse off from a tax perspective than if the GRAT had never been created.

Soon, this strategy may be too good to be true. Changes to the Internal Revenue Code may reduce the benefits of GRATs by requiring a minimum remainder interest and a longer term of years. Because it is expected that any legislation would exclude existing GRATs, unusual opportunities exist and should be seized quickly.

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