Use a GRAT to Save Estate Taxes

Grantor Retained Annuity Trusts (GRATs) allow you to transfer property to loved ones estate tax free. With a GRAT, you create a trust and transfer privately-held stock, marketable securities or commercial real estate to it. The Trust pays you a fixed annual payment during the term of the trust. In valuing gifts to a GRAT, the IRS relies on tables that assume the assets transferred to the GRAT grow at a rate equal to 120 percent of the current average market yield on U.S. Treasury bills maturing in 3 to 9 years. This rate is known as the 7520 rate after Internal Revenue Code §7520. The great news is that interest rates have dropped so much in recent months that the 7520 rate stands at historic lows. For June, 2008, the 7520 rate is only 3.8%.

If the total return of the GRAT (i.e. – dividends plus capital gains or rental income plus appreciation) exceeds the 7520 rate, property will pass to your beneficiaries free of estate tax. Given that the value of both real estate and securities has declined recently, if you believe the markets will turn around it would seem a propitious time to fund a GRAT. If you own a fast-growing business, a gift of your privately-held stock to a GRAT could also prove useful.

An Example

Let's say you are 60 years old and own a commercial real estate parcel worth $1 million. You rent the real estate for $5,000 per month and the tenants pay all expenses under a triple-net lease. You put the parcel in the GRAT for, say 10 years. You can serve as Trustee during the 10-year term. You transfer the real estate by deed to yourself, as Trustee of the GRAT. Under the IRS tables, you are treated as having made a taxable gift of $508,462 based on the current 3.8% rate. The gift of $508,462 represents the current value of the remainder interest transferred to beneficiaries of the GRAT. If the real estate produces a 6% return each year ($5,000/month) and appreciates 3% in value each year, the donor will have received $600,000 and a total of $1,471,483 will pass to the beneficiaries at the end of the GRAT free of estate taxes.

Just think what this means. You were able to retain the income from the real estate for 10 years, you made a gift that was taxed at half the value of the property at the time you transferred it, and your beneficiaries received a property worth $1,471,483 without owing any estate tax on it.

The Ultimate Disposition

What happens to the property at the end of the GRAT term? Let's say that you have 3 children who you would like to benefit from this GRAT. If the property goes into trust for them, you can choose the Trustee who will manage the property. You can remain as an administrative Trustee after the end of the income term, but the Co-Trustee must have the sole right to make distribution decisions. The Co-Trustee cannot be one of the beneficiaries. You can also designate the successors to that Trustee. Thus, you can assure that the property will remain well managed even after you are no longer receiving income from the trust.

Risks to Consider

To obtain the benefits of a GRAT, you must outlive the term of the GRAT. The shorter the term you select for the GRAT, the greater the remainder gift to the beneficiaries. A GRAT that pays you income for many years is a bit of a gamble. If your health is sound, however, it may not be much of a gamble.

You must also obtain a professional appraisal to assure that the gift tax calculations hold and to assure that the IRS has no basis to contest the gift tax valuation years later. The asset transferred to the GRAT must generate enough income to pay the annuity each year. Otherwise, the grantor must receive a portion of the principal of the asset, requiring an updated appraisal.

The Zeroed-Out GRAT

Each person has a $1 million dollar lifetime federal gift tax exemption and a $2 million dollar Connecticut lifetime gift tax exemption. If you do not have sufficient gift tax exemption remaining or you simply want to conserve your lifetime gift tax exemptions for other tax-saving strategies, you can increase the amount of the annuity so that the value of the gift is zero. This is called a “zeroed-out GRAT.” When the GRAT ends, property will pass to your beneficiaries free of estate tax. A “zeroed-out GRAT” can work well if you own a minority interest in the asset that appreciates rapidly and/or the asset will generate a enough cash flow to sustain the higher annuity payment.

Conclusion

If the value of your assets (including life insurance) exceed the estate tax exemption ($2.0 million in 2008 and $3.5 million in 2009) and you own an asset that generates considerable cash flow, give us a call to review the merits of creating a GRAT. With interest rates reaching historic lows, more property will pass without estate tax to your beneficiaries. Now is the time to consider this strategy.