Grantor Retained Annuity Trusts & Grantor Retained Unitrusts

Grantor retained annuity trusts ("GRATs") and grantor retained unitrusts ("GRUTs") are trusts that are designed to remove assets from an individual's estate at reduced transfer tax costs. In general, making lifetime gifts of appreciating property saves the transfer taxes that would otherwise be due on the appreciation had the grantor retained the property until death. GRATs and GRUTs magnify the advantage of lifetime gifting of appreciating assets. GRATs and GRUTs are particularly useful for assets that are expected to appreciate at a rate that exceeds the payments to be made to the grantor, as discussed below in greater detail.

Structure of a GRAT or GRUT

The individual who transfers property to a GRAT or a GRUT (the "grantor") retains the right to specified payments from the trust for a period of years, after which the property passes to the beneficiaries specified in the trust document. The value of the gift to the trust for gift tax purposes is the value of the property transferred less the value of the grantor's retained interest, so that the value of the gift can be substantially less than the market value of the property.

GRATs and GRUTs are governed by Chapter 14 of the Internal Revenue Code. Pursuant to Chapter 14, only "qualified interests" retained by the grantor may be deducted from the full value of the property when valuing a gift. An income interest in a GRAT or GRUT is a qualified interest if the trust meets the following requirements of Chapter 14.

First, a GRAT or GRUT must be irrevocable. It cannot be changed by the grantor in any way after it is established. However, the grantor of a GRAT or GRUT may be the trustee of the trust, which allows the grantor some continued control over the trust property.

In addition, the trust must pay the grantor of the trust a fixed amount at least annually. The fixed amount may be a stated dollar amount or a fixed percentage of the initial value of the trust assets, in which case the trust is a GRAT, or a fixed percentage of the net fair market value of the trust assets valued annually, in which case the trust is a GRUT. With a GRAT, the amount of payments the grantor will receive is determined and fixed when the trust is initially funded. By contrast, payments under a GRUT vary annually according to the value of the trust property. (The trust may also allow all income of the trust to be paid to the grantor. However, the grantor's right to receive the income in excess of the annuity amount is not a "qualified interest" and may not be deducted from the value of the property when valuing the gift for tax purposes.) In any case, if any assets other than cash or publicly-traded securities are used to satisfy the annuity or unitrust obligation, an appraisal must be obtained to ensure that the value of such assets as of the due date equals the annuity or unitrust amount payable. However, the trustee cannot borrow the annuity or unitrust amount from the grantor (directly or indirectly) in lieu of making the actual payment; and the trustee and the grantor may not prepay the value of the remaining annuity or unitrust obligation prior to the end of the term. That said, with respect to a GRAT, if the trustee runs out of assets to satisfy the annuity obligations (e.g., because the assets have depreciated), then no further payments need be made.

The beneficiary of the payments may be the grantor himself, his spouse, or any ancestor of the grantor or the grantor's spouse. No one other than the specified beneficiaries may receive distributions during the term of the trust.

The term of the payments must either be for the life of the specified beneficiaries or for a term of years. However, as a practical matter, the term should be for a term of years in order to achieve the maximum transfer tax savings. If the grantor dies during the term of the trust, all or some of its assets will be included in the grantor's estate; therefore, a term of years which the grantor is expected to survive should be chosen.

No additional contributions may be made to a GRAT during its term, but additional contributions may be made to a GRUT.

Gift Tax Consequences

Because the grantor's gift to the GRAT or GRUT is a gift of a "future interest" that does not qualify for the annual gift tax exclusion (currently $15,000 per donee per year, and increased periodically for inflation), it is a taxable gift that must be reported on a gift tax return. However, the grantor may use part of his cumulative lifetime gift tax exemption amount (currently $11,400,000) to avoid actually paying tax on the gift. Gifts made in excess of the annual exclusion amount and the cumulative $11,400,000 gift tax exemption are subject to gift tax during the grantor's lifetime. Ironically, the payment of gift tax will have the added benefit of removing the amounts paid as tax from the grantor's estate tax base (if the grantor lives for three years after the gift).

The value of the gift is the value of the property transferred to the trust minus the value of the unitrust or annuity interest that is retained by the grantor. This retained interest is generally valued by reference to actuarial tables published by the Internal Revenue Service and depends on the age of the grantor, the length of the trust's term, the stated dollar amount or fixed percentage constituting the retained payments from the trust, and the interest rate published by the Service for the date of the gift. In general, the longer the term or the greater the fixed percentage, then the greater the value of the retained interest and, therefore, the lower the amount of the gift. The IRS has acquiesced in the Tax Court's holding in a case, Walton v. Commissioner, in which the grantor's retained interest (with a short term and high fixed percentages) was valued near zero and, thus, only a nominal taxable gift occurred upon creation of the GRAT. This case provides confirmation that it is possible to structure a GRAT in such a way as to have little gift tax implication.

Estate Tax Consequences

If the grantor dies during the term of the trust, a portion of the trust is included in his estate for estate tax purposes. The extent of this portion is not clear under current law. The Service's rulings with respect to charitable trusts indicate that this portion should be that amount that would generate the required annuity payments for the remainder of the trust term. However, there is also some authority to indicate that the Service might attempt to include the entire amount of the trust property in the grantor's estate. A GRAT or GRUT could provide that the amount of trust assets that would be included in the grantor's estate be paid to the estate in order to provide funds necessary to pay any taxes due on any included amounts.

If the grantor dies after the end of the trust term, the trust assets will not be included in his gross estate, unless the assets are held in continued trust for the remainder beneficiaries and the grantor has retained an impermissible level of control over that continued trust.

Generation-Skipping Transfer Tax Consequences

The use of a GRAT or GRUT effectively "freezes" the value of property at its discounted value at the time of the gift. However, pursuant to regulations issued by the Service, this "freezing" will not apply to the generation-skipping transfer tax. In other words, an individual may allocate his exemption from the generation-skipping transfer tax to the trust property only after the expiration of the term, and then he must allocate it to the full value of the trust assets at that date. Therefore, a GRAT or GRUT is generally not an appropriate vehicle for generation-skipping transfer tax planning.

Income Tax Consequences

The grantor of the GRAT or GRUT is treated as its "owner" for income tax purposes during the term of the trust. This means that the grantor is taxed on all of the trust's income regardless of whether it is distributed or retained by the trust. This feature may allow the grantor to effectively increase the value shifted to the trust's remainder beneficiaries by paying taxes on income realized in the trust.

Conclusion

In summary, transfer tax savings are achieved through a GRAT or GRUT because the value of the gifted property is fixed for transfer tax purposes at its value on the date of the gift reduced by the value of the grantor's retained interest, instead of the full value of the gift. The optimal tax savings are achieved if the income from, or appreciation on, the property exceeds the amounts paid annually to the grantor and if the grantor survives the term, because any increases in value will escape additional transfer tax. To the extent that the property in the trust depreciates in value, the tax savings are eroded because the property was taxed with reference to its value on its date of transfer. Thus, it is critical to carefully choose assets that are expected to appreciate in value to contribute to a GRAT or GRUT.