Estate tax planning: Use a GRAT to gift subchapter S stock or real estate assets

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The Grantor Retained Annuity Trust, or "GRAT," is an under-utilized tax planning technique. A GRAT is frequently poorly understood, and it is therefore not incorporated into many estate plans. S corporations and real estate are ideal properties to use to fund a GRAT.

A GRAT is an irrevocable trust that must contain the following terms:

1. Prohibit distributions to or for the benefit of any person other than the grantor of the interest during the term of the interest;
2. Fix the term of the interest for the life of the holder, for a specific term of years, or shorter of those periods;
3. Prohibit prepayment of the income interest;
4. If the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, require payment adjustments or repayments as a result of any incorrect determination of the fair market value of the property;
5. Require the pro rata computation of the annuity amount in the case of a short taxable year and the last taxable year of the term;
6. Prohibit additional contributions to the trust.

Income tax considerations: In the case where the trust is considered as a grantor trust, the grantor is considered the owner of the trust. Accordingly, the grantor is taxed on all of the trust's income during the trust's life.

Gift tax considerations: When a person gives a gift, the value of the gift is equal to the gifted property's fair market value. In a GRAT, the gift is valued at the property's fair market value at the time the property is transferred to the trust less the present value of the retained annuity. Technically, the retained annuity should be a "qualified interest." Based on these computations, it is possible for the value of the retained annuity to equal the property's fair market value, resulting in a zero gift. This is commonly referred to as a zero-out GRAT. When using a zero-out GRAT, if the property grows greater than the IRS interest rates, then the growth in excess of the section 7520 interest rate is gifted to the family member tax-free.

Estate tax considerations: If the grantor dies after the trust term, then no trust property is included in the grantor's estate. If the grantor dies before the trust term, then some or all of the property can be included in the grantor's estate. Therefore, when determining the GRAT's life, it is common to use short term GRATS i.e. 2-4 year term rather than longer term GRATs to prevent any part of the trust value included in the grantor's estate. As property value changes frequently, the use of successive short term GRATs alleviate volatile in the market place as well as causing GRATs property included in the grantor's estate. For valuation purposes, if the grantor retains a "reversionary interest" then the estate and gift tax computations are more complex.

Why set up a GRAT in 2012?

Currently, the section 7520 interest rate, real estate values and business values are at historic lows, and as a result it is easier to choose property that can grow greater than the section 7520 rate to fund a GRAT. In a low interest rate environment, the annuity that the GRAT must pay the grantor is low, making it easier for the trust's growth to exceed the IRS interest rate, thereby increasing the amount left in the trust.

It should be noted that there is no limitation on the ownership of LLC interests; accordingly, a GRAT can be an owner of a LLC. Additionally, a GRAT that is considered for income tax purposes as a grantor can be an eligible shareholder of an S corporation.

Lastly, there is much discussion in Congress on the future of estate taxes, including the use of a zero-out GRAT. It is certainly an ideal time to get familiar with and consider a GRAT as an integral part of your estate plan.

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