Grantor Retained Annuity Trusts (GRATs)

Suppose your financial objectives include income and leaving a legacy for your heirs. In that case, it's essential to work with a financial professional familiar with your many options, including older tools.

Grantor retained annuity trusts (GRATs) gained popularity in 2000 after a favorable ruling by the U.S. Tax Court toward a wealthy family in the retail business. This ruling allowed for zeroed-out GRATs, for which annuity payments return the original assets to the grantor, leaving only the appreciated value for the beneficiaries. You don't need to be a billionaire to take advantage of a GRAT, which has potential for individuals and families of many income levels.

A GRAT is a financial tool used to reduce taxes on large financial gifts to family members. It involves creating an irrevocable trust for a specific period, transferring assets into the trust, and paying an annuity to the grantor each year. When the trust expires and the final annuity payment is made, the beneficiary receives the assets with minimal or no gift taxes. GRATs can be a valuable tool for transferring wealth while minimizing gift tax liability. They allow the grantor to move asset appreciation to the remaining beneficiaries, reducing the value of the grantor's assets subject to estate tax. A GRAT is established for a specific number of years.

Typically, a grantor sets up zeroed-out GRATs for a specific number of years, for which the present value of the annuity stream equals the total value of the property used to fund the GRAT.[1] This means that the remainder interest has a value of 0, making it a zero-value gift for tax purposes. Any assets remaining in the GRAT after the final annuity payment pass to the remainder of the beneficiaries without incurring gift tax.[1]

When setting up a GRAT, the grantor contributes assets to the trust, but—this is the crucial part—the grantor retains the right to receive the original value of the assets contributed over the term of the trust, along with the rate of return specified by the IRS. When the trust ends, the remaining assets (the appreciation of the original holdings minus the IRS-assumed return rate) go to the beneficiaries.[1]

There are risks involved with GRATs. If the grantor dies before the trust expires, the assets become part of their taxable estate, and the beneficiary receives nothing. Additionally, if the assets depreciate or the IRS's assumed return rate is low, the GRAT may not provide the intended advantages.

GRATs are most useful for individuals with significant estate tax liability, including those who freeze the value of their estate by transferring the appreciation onto their heirs. For example, if someone expects an asset to grow from $10 million to $12 million over two years, they can transfer the $2 million difference to their heirs without incurring taxes.

GRATs are particularly popular among individuals who own shares in startup companies because the stock price appreciation for IPO shares often exceeds the IRS's assumed rate of return. This allows more money to pass to beneficiaries without affecting the grantor's lifetime exemption from estate and gift taxes.

From an income tax perspective, the grantor is responsible for the GRAT's income tax liability during the GRAT term. During the remainder of the term, tax liability can flow through to the grantor or be paid by the trust, depending on the structure.

In recent years, there have been proposals to limit the benefits of GRATs, so individuals may want to take advantage of this strategy before any potential legislation passes.

The reason the GRAT remains popular is clear: For many, these trusts have created a reliable method for minimizing taxes and passing wealth on to future generations. Despite being relatively under the radar, it remains effective and prevalent among those seeking to sustain their finances.

1. JournalOfAccountancy.com, September 19, 2023

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