

Leave More to Your Children With a GRAT

Grantor retained annuity trusts (GRATs) are among the most powerful leveraging tools in estate planning. A GRAT involves an irrevocable current gift of the right to receive assets in the future while retaining the income stream earned by those assets. This is an effective way to transfer wealth from one generation to the next with minimal gift tax cost.

Why Gift a Future Interest?

Over time the value of a gift of a future interest erodes — \$1 today will be worth much less in 10 years. For example, if an asset is worth \$2 million today, the current value of the right to receive that asset in 10 years is about \$926,387. If you gift the entire \$2 million today, the gift tax due on the transfer is \$588,000. If you wait 10 years to make a gift of the assets, you will still owe \$588,000 in gift taxes. (Actually, with the increase in the unified credit under the new tax law, gift tax on a \$2 million gift will be \$435,000, but for the purposes of this article, we will assume a constant unified credit.)

If, instead, you make a gift today of the right to receive the funds in 10 years, then the actual gift today is only \$926,387, and you pay a tax of only \$155,000. In 10 years the donee will own the entire asset (and perhaps even some appreciation in the asset), and you will owe no further gift tax.

How Does the GRAT Work?

To make a current gift of a future interest, you must retain the right to receive a fixed dollar amount per year — an annuity. The value of the future interest is determined by valuing the annuity that is retained and subtracting it from the total assets transferred.

This involves discounting the retained annuity payments to account for the fact that they are not being received currently. To discount a future payment, we assume a specific interest rate that will reflect the predicted rate at which the asset will grow.

This interest rate, referred to as the “7520 rate,” is published monthly by the Internal Revenue Service (IRS). Fluctuations in the rate can greatly affect the gift. For example,

Harry, age 60, establishes a GRAT with \$1 million and retains the right to receive an 8% annuity (\$80,000) each year for 10 years. Depending on the interest rate, his current gift of the future interest will be as follows:

Assets Transferred	7520 Rate	Value Of Gift
\$1,000,000	7%	\$479,336
\$1,000,000	8%	\$501,848
\$1,000,000	9%	\$522,872

Of course, a change in the annuity rate will alter the result as well. Assuming the same basic facts as above, if the 7520 rate is at 8%, here is the result:

Assets Transferred	Annuity Rate	Value Of Gift
\$1,000,000	7%	\$564,117
\$1,000,000	8%	\$501,848
\$1,000,000	9%	\$439,579

Further Leveraging the Gift

You can further leverage the gift by contributing assets to the GRAT that are likely to outperform the IRS rate. Also, a double discount is possible if you choose an asset for which a minority interest or lack-of-marketability discount is available.

Some types of assets to consider are:

- Stock in a closely held company that could be subject to an initial public offering in two to three years.
- Stock that could be valued using lack-of-marketability, lack-of-control or minority discounts, such as S corporation shares that can generate cash flow to pay to annuity or minority limited partnership interests from a family limited partnership.

Transfer Wealth Effectively

A GRAT can be a highly effective vehicle for transferring wealth to the next generation at a minimum transfer tax cost, provided that the growth in the value of the asset combined with its income exceeds the rate of return assumed by the IRS.