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April 1, 2010

Grantor Retained Annuity Trusts (GRATS)

The Grantor Retained Annuity Trust (GRAT) is an irrevocable trust that you create. At the end of its life it will transfer the assets remaining in the trust to someone else (normally your children). While the trust is in existence, it pays you a fixed amount each year-an annuity.

The GRAT is a sophisticated way to remove assets from your estate with no or minimal gift tax consequences. It also allows you to enjoy the income from the assets transferred to the GRAT for a predetermined period of time. At the end of that term your children will ultimately receive the gift.

The first question is, how much of the money in the trust isn't subject to gift tax? This depends partly on the amount of money the trust will pay you each year, the number of years the trust will run, your life expectancy, and the return of the IRS expects the assets in the trust to earn each year.

The rate of return used in this calculation is set monthly by the IRS, according to the formula that is pegged to the intermediate-term Treasury rates. If the interest rates are low, the amount of money that is needed to fund those annual payments, and the amount of money in the trust that passes on tax free to the beneficiaries, is higher.

Additional discounting can be achieved if the assets transferred to the GRAT constitute minority or nonmarketable business interest property. Properties such as nonvoting "S" corporation stock or Family Limited Partnership interests can enhance the already substantial gift discounting available with GRATS.

The real tax saving is a function of how much the value of the trust assets actually increases during the term of the trust. In effect, the GRAT freezes the value of the assets, for tax purposes, at what they are worth at the time the trust is established. If the trust earns more than the IRS expects, the excess appreciation passes on tax free to your beneficiaries.

Because the IRS rate is locked in at the time you establish the GRAT, this strategy is especially effective when interest rates are low. For example, assume you fund a GRAT with stock currently valued at $1 million. Assume that the stock returns 10 percent per year during the trust's 12-year life. If the IRS applicable federal rate is 9 percent (the IRS expects the trust to earn 9 percent annually), creating a GRAT will result in a tax-free gift of $858,300 when the trust expires. But, if the IRS mandated rate is 5.4 percent, the tax-free gift will be $993,800-nearly 16 percent more.

The tax savings increases over time. The longer the property stays in the trust, beating the IRS mandated interest rate, the more growth moves to your beneficiaries tax free. Beating the IRS rate is crucial. If the trust earns less than the IRS mandated rate, setting up the GRAT will be a mistake. The gift tax bill will be higher than either the gift or estate tax levy on the rebinding assets would have been had those assets been passed on without a GRAT.

Here, similar to the situation with qualified personal residence trusts, you want to outlive the trust term. If the person establishing the trust dies before the trust expires, most or all of the remaining assets will be subject to estate tax.

The GRAT is a calculated gamble that the trust assets will appreciate faster than the IRS hurdle rate, the IRS hurdle rate is based on recent market conditions, not future prospects.