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# Special Feature

## In uncertain times, GRATs can provide certain benefits

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With the Trump administration and Republican leadership proposing to repeal the federal estate tax, many estate planning practitioners are recommending to clients that they "wait and see" what happens in Washington before embarking on an aggressive program of making substantial lifetime gifts.

For many clients, this is probably sound advice. Yet for other clients who wish to make substantial lifetime gifts, it still makes sense to consider utilizing the Grantor Retained Annuity Trust — or GRAT — to convey assets to the grantor's children.

A GRAT is a technique authorized under the Internal Revenue Code to transfer property to children and other beneficiaries, essentially free of gift tax. This is desirable, as the latest tax proposals do not call for the repeal of the federal gift tax.

Even though interest rates have been rising of late, they are still relatively low, and GRATs are particularly effective in a low-interest-rate environment.

### How do GRATs work?

The basic idea is for the grantor/parent to contribute certain assets to a GRAT. The grantor retains the right to an annuity interest in the GRAT for a fixed term of years (for example, five years). At the end of the five-year term, any assets remaining in the GRAT will pass to the grantor's children or to a trust for their benefit.

GRATs typically provide for a fixed annuity payment, usually expressed as a percentage of the original value of the property conveyed to the GRAT. For example, if $3 million in assets were conveyed to a five-year GRAT and the trust instrument calls for a fixed annuity payout rate of 22 percent each year, the trustee would distribute $660,000 annually to the grantor in each year of the GRAT.

The trustee would use interest and dividends, if any, generated by the assets to pay the annuity. To the extent these were insufficient to pay the annuity in full, trust principal would be transferred back to the grantor to satisfy the annuity payment. All appreciation in excess of the amount required to make the annuity payments would accumulate for the children's benefit.

For gift tax purposes, the value of the gift to the GRAT equals the value of the property transferred minus the present value of the annuity interest retained by the grantor.

The annuity rate is purposely set to reduce or eliminate the gift tax cost by making the present value of the annuity interest equal (or nearly equal) the value of the property transferred to the GRAT. Accordingly, the grantor would pay little or no gift taxes on the transfer. Here is an example:

Gift tax value of assets transferred to GRAT=$3,000,000

Present value of retained annuity= - 2,999,900

Gift tax value of gift to children=$100

The present value of the retained annuity interest is calculated using interest rates published monthly by the IRS. Currently, the IRS's assumed rate of growth of the GRAT assets is low (this month it is 2.4 percent). Therefore, if the income plus the growth in value of the assets transferred to the GRAT exceeds the IRS's assumed rate of 2.4 percent over that five-year period, all of that excess will pass for the children's benefit transfer tax-free.

Let us consider two types of GRATs that are frequently utilized by practitioners for their clients.

### GRATs for closely held businesses

GRATs are particularly effective to convey equity in a closely held business that is both profitable and a pass-through entity for income tax reporting purposes (e.g., S corporations, partnerships or LLCs).

If the client wishes to pass all or some portion of the closely held business to his children, the GRAT strategy is ideally suited to accomplish that goal. Pass-through entities that are profitable will typically make large tax distributions to owners to allow them to make their tax payments to the government.

If a GRAT is a shareholder, the tax distributions will be made to the GRAT, and, in turn, the GRAT will use those distributions to satisfy in whole or in part the required annuity payment due the grantor. Thus, the tax payment that would have been paid to the grantor anyway can serve double duty to form at least part of the annuity payment due the grantor. The economic effect of this result is that a greater portion of the GRAT assets will be left at the end of the term for the grantor's children.

### Rolling GRAT strategy

The strategy is often utilized by wealthy clients with a diversified portfolio of publicly traded securities who wish to convey some of the portfolio to their children.

Because GRATs do not require the allocation of federal gift tax exemption, the client essentially cannot lose in the transaction. If assets underperform in the GRAT, the grantor simply gets her assets back. But if the assets outperform the assumed rate of return, then this excess will pass to the children free of gift tax.

For this reason, it makes sense not to convey a diversified portfolio of securities to a single GRAT. Instead, the client should separate the winners from the losers. Ideally, a separate GRAT would be created for each stock to be conveyed.

Often, clients prefer to establish so-called "sector GRATs" with company stock in similar sectors being held in a single GRAT. The idea, of course, is that companies in the same sector tend to go up or down in tandem.

These GRATs have a term of two years. After payment of the first year's annuity, which typically would require a substantial repayment of the stock (or sector companies) back to the grantor, the grantor will turn around and establish a new GRAT. These "rolling GRATs" can succeed in conveying substantial wealth to children currently.

### Conclusion

While many of the tax reform proposals coming out of Washington promise a repeal of the estate tax, they also call for retention of the gift tax. Yet some clients still want to transfer assets to their children prior to death. The GRAT strategy can be an effective and efficient way of achieving the client's goals. MLW