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Personal Wealth, Estates and Trusts Practice
Saul Ewing LLP
JUNE 2012

When Interest Rates Are Low, A GRAT Can Be Great

By Sheldon S. Satisky

SUMMARY

In today's low interest rate environment, the use of a particular type of trust, a grantor retained annuity trust (GRAT) can provide a great way to make tax-free gifts.

What is a GRAT?

A GRAT is a trust that pays to the person who sets up the trust ("grantor") an annual amount for a specified time reserved by the grantor based on a percentage of the assets transferred. At the end of the term, when all of the fixed annuity payments to the grantor have been made, the remaining assets of the GRAT pass to the beneficiary or beneficiaries chosen by the grantor.

What about federal gift taxes?

In its current form, the federal gift tax system limits an individual's ability to make tax-free gifts. At this time, an individual is permitted to make cumulative lifetime gifts of $5.120 million without paying gift tax. Because this $5.120 million limitation is scheduled to be reduced in 2013 to $1 million, finding ways to make gifts without paying gift tax can become an important consideration. For that reason, the use of a GRAT should not be overlooked.

For federal gift tax purposes, the transfer of assets to a GRAT is a taxable gift of the present value of the assets that will eventually pass to the beneficiary. The amount of the taxable gift, which generally counts against the gift tax limitation noted above, is calculated using an interest rate provided by the IRS. The IRS interest rate represents an assumed rate of total return (both income and growth) that the assets of the GRAT will produce. In other words, based on current economic conditions, the IRS makes a prediction as to what type of total return on investment the GRAT will generate.

For June or July of 2012, the IRS interest rate assumption is a low 1.2 percent. Stated differently, the IRS is predicting that the assets of a GRAT created in June or July, 2012, will produce a conservative 1.2 percent rate of total return. This conservative prediction by the IRS can work in the grantor's favor. If, for example, over the course of the specified term of years, the value of the GRAT grows at a rate in excess of 1.2 percent, there will be an amount that will pass tax-free to the beneficiary (without counting against the gift tax limitation). The larger the rate of growth in excess of 1.2 percent, the greater the amount that will pass tax-free to the beneficiary.

The "Zeroed Out" GRAT

In the event an individual has used up the entire gift tax limitation noted above (or just does not wish to use up a portion of that limitation), the use of a "zeroed out" GRAT should be considered.

Contacts:

Robert H. Louis
Co-Chair

Sheldon S. Satisky
Co-Chair

David R. Berk
Ronald P. Colicchio
Russell J. Fishkind
Richard T. Frazier
Ryan R. Gager
Jeffrey S. Glaser
Nancy S. Hearne
Maurice D. Lee, III
John F. Meigs
Eileen D. O'Brien
Cathleen C. Opel
Nancy A. Slowe

A zeroed out GRAT is a variation of the GRAT described above. The difference is that a zeroed out GRAT provides for an annual payment back to the grantor to be sufficiently high to cause the present value of the gift to the ultimate trust beneficiaries to be zero. Like its name suggests, the zeroed out GRAT results in a taxable gift of zero (and as a consequence, does not use up any of the gift tax limitation).

What about federal estate taxes?

The use of a zeroed out GRAT presents a no-lose proposition. If the total return on the assets of the zeroed out GRAT exceeds the IRS prediction, all of the excess growth will pass tax-free to the beneficiary. On the other hand, if the total return does not exceed the IRS prediction, all of the assets contributed to the zeroed out GRAT by the grantor will be returned to the grantor in the form of annuity payments. Except for the transaction costs, the grantor is no worse off under those circumstances than if the zeroed out GRAT had never been created.

If the grantor survives the specified term of years, the assets remaining in the GRAT will not be included in the grantor's gross estate for federal estate tax purposes. Conversely, if the grantor dies before the specified term of years has ended, the GRAT will be included in the grantor's gross estate. Again, in that event, the grantor is no worse off than if the GRAT had never been created.

An Example

A 60-year-old grantor contributes $5 million of stock this month to a five-year zeroed out GRAT that will terminate with a distribution of the assets remaining in the GRAT to his children. The annual annuity to the grantor is $1,036,291 payable at the end of each year. If the stock grows in value at 5 percent per year, the children will receive $655,245 in value at the end of the five-year term, free of any gift or estate tax. However, if the stock appreciates at 10 percent per year, the amount of value passing to the children at the end of the five-year term is $1,725,890.

Conclusion

In a low interest rate environment, both the GRAT and the zeroed out GRAT remain great estate planning options. To learn more about these unique estate planning opportunities, please feel free to contact any member of the Saul Ewing LLP Personal Wealth, Estates and Trusts Practice.

This Alert was written by Sheldon S. Satisky, Co-Chair of the firm's Personal Wealth, Estates and Trusts Practice. Sheldon can be reached at 410.332.8732 or ssatisky@saul.com. This publication has been prepared by the Personal Wealth, Estates and Trusts Practice for information purposes only.