GRATs

Leveraging GRATs as a pertinent, timely estate planing option

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A Grantor Retained Annuity Trust (GRAT) freezes and discounts the value of larger gifts at their current discounted values rather than at their date of death values. GRATs work particularly well under two circumstances, both of which are currently present due in part to the COVID-19 crises: (i) depressed values of businesses and other investments and (ii) very low IRS interest rates that are used to value gifts.

Smart Business spoke with Wilbur D. Dahlgren, an attorney at Semanoff Ormsby Greenberg & Torchia, LLC, about how a GRAT works and why employing one now as part of your estate and business succession planning may make sense.

HOW IS A GRAT CREATED AND FUNDED?

With a GRAT, the grantor — the person creating the trust — transfers certain assets to a trust while retaining an annuity interest in the trust for a term of years. After the term expires, the trust terminates and the trust fund is paid to the trust's remainder beneficiaries.

A GRAT splits the ownership of the assets put in the trust. The grantor retains an annuity interest but irrevocably transfers the future ownership of the gifted property. This irrevocable transfer of the future ownership of the trust fund is considered a taxable gift for federal gift tax purposes.

The gift valuation process starts with determining the current value of the assets placed in the trust, usually publicly traded or closely held stock. If the stock is for a closely held business, the IRS usually allows a 20 percent reduction in the value because of the lack of marketability and lack of a controlling interest. The value of the gift is further reduced by the present value of the grantor's annuity interest, calculated using IRS tables, currently at favorable lower interest rates.

The key is that the value of the remainder interest is 'frozen' as of the date the trust is created, as reduced by the discounts and the present value of the grantor's annuity. The value of any growth in value after the gift will not be subject to federal estate or inheritance tax.

The catch with GRATs is that if the grantor dies before the term of years expires, the entire amount of the trust assets will be brought back into the grantor's estate for estate tax purposes.

WHAT MIGHT GRAT BENEFITS LOOK LIKE?

Let us assume that a closely held business owner, age 60, desires to transfer a 40 percent interest in his corporation to his children using a GRAT. Because of market conditions, the value of the business is comparatively depressed (let's assume it's worth $2 million); however an increase in demand for the products and services it provides may significantly increase the value of the business over the next three years. A GRAT is created with a three year term to shift the anticipated appreciation out of his estate for gift and estate tax purposes. If the business is currently valued at $2 million, the starting point for the 40 percent interest is $800,000.

The next step in the discounting/freezing process is to reduce the $800,000 by the lack of marketability/minority interest discounts. Usually 20 percent is the safe discount accepted by the IRS. After these discounts, the gifted stock is considered to be worth $640,000.

Let's assume that the gifted stock will generate annual dividends of $40,000 — we will make this the annuity amount payable back to the grantor over the three year term of the GRAT.

Using IRS tables, and the September 2020 interest rate of .4 percent, the present value of the grantor's annuity interest is $103,895. The present value of the remainder interest given to the grantor's children is therefore $536,105 ($640,000 minus $103,895).

Let's assume that at the end of the three-year term the stock in the GRAT actually appreciated in value to $1,500,000. So the grantor transferred an asset valued at $1.5 million, but for gift tax purposes the gifted value was only $536,105. That is what is referred to as 'leveraging.'

To determine if a GRAT makes sense, business owners should consult with a knowledgeable estate planning attorney to review circumstances and, if a GRAT makes sense, assist in the creation, funding and proper reporting of the GRAT to the IRS. ●