

Grantor retained annuity trust (GRAT)

The concept

A GRAT is an irrevocable trust to which the grantor transfers property in return for the right to receive an income stream for a certain period of years. At the end of the income period, the trust terminates and the residuary property in the trust passes to the trust's remainder beneficiary.

Benefits

This is a technique for passing highly appreciated or income-producing property to future generations at minimal or no gift-tax cost.

Tax considerations

- The remainder interest is a gift at the time that the trust is established
- The amount of the gift is determined by subtracting the present value of the grantor's income interest from the value of the assets transferred to the trust as of the transfer date
- If the value of the retained income interest equals the value of the assets transferred to the trust, the value of the gift is zero; this means that the transfer to the trust "freezes" the value of the assets in the grantor's estate by converting them into a fixed annuity interest payable to the grantor; the result is that all of the post-transfer appreciation on the transferred assets is removed from the grantor's estate
- The trust should be considered a grantor trust, with the result that the grantor pays the trust's income tax liability, meaning that the trust's assets grow income tax free for the benefit of the remainder beneficiary
- If the grantor does not survive the term of the trust, the trust property is included in the grantor's gross estate
- The grantor could purchase a term life insurance policy for the duration of the income period to cover any potential estate tax stems from the trust property being brought back into the grantor's estate

Steps

1. The grantor transfers highly appreciated or income-producing property to the trust in return for an income interest for a certain period of time
2. The trust makes income payments to the grantor for the duration of the trust
3. At the end of the grantor's income interest, the trust automatically terminates and the remaining trust assets go to the trust's remainder beneficiary

How it works

