Morgan Stanley

PRIVATE WEALTH MANAGEMENT

Grantor Retained Annuity Trusts

Wealth and Estate Planning Strategists
Family Office Resources

Introduction

A Grantor Retained Annuity Trust (GRAT) is an irrevocable trust to which the grantor transfers property in exchange for a fixed annual annuity over a term of years. At the expiration of the term, any property remaining in the trust is paid to (or held in further trust for) one or more designated beneficiaries.

Gift Tax

The grantor is deemed to make a taxable gift equal to the value of the remainder interest passing to the designated remainder beneficiaries. The value of the taxable gift is determined by subtracting the value of the grantor's retained annuity from the fair market value of the assets transferred to the trust. The present value of the annuity stream is calculated using the IRS's prescribed discount rate known as the "7520 rate" (after its Internal Revenue Code section). The IRS changes the 7520 rate every month based on market conditions, so the annuity is valued using the rate in effect in the month that the assets are transferred to the trust. The transfer to the trust can be structured so the value of the grantor's retained interest is virtually equal to the market value of the property placed in trust, in which case only a very small, or zero, taxable gift results ("zeroing out" the GRAT). The taxable gift (however small) will be reported on the grantor's gift tax return. The gift of the remainder interest cannot be excluded from the federal gift tax as an annual exclusion gift and therefore will use a portion of the grantor's federal gift tax exemption, currently $12.06 million in 2022, or if no exemption remains, the grantor will pay federal gift tax.

Estate Tax

All or a portion of the value of the GRAT's assets will be included in the grantor's gross estate for federal estate tax purposes if the grantor dies during the term of the GRAT. (The actual amount included in the deceased grantor's estate is that amount of corpus necessary to yield the annual annuity payment which could be the entire value of the GRAT). Therefore, the term of the GRAT must be considered carefully. In essence, the term should be long enough so as to capture any significant appreciation, but typically should not exceed the grantor's life expectancy. Many advisors suggest the shortest term (generally 2 years) so as to minimize the mortality risk. With a 2-year GRAT, the grantor will receive roughly half of the originally transferred assets in each of the 2 years that the annuity is paid. The grantor can "re-GRAT" each annuity payment to a new GRAT. This plan is often referred to as cascading or rolling GRATs and can be effective in capturing appreciation in good years and allowing the grantor to take advantage of lower valuations in down years.

Income Tax

During the term of the GRAT, the grantor is treated as the owner of the trust property for income tax purposes and, accordingly, the grantor is taxed on all trust income (but not the annuity payments themselves).

Advantages

The GRAT can produce federal estate and gift tax savings if the trust property produces a return in excess of the IRS discount rate over the term of the trust. The grantor effectively shifts all of the return on the trust property in excess of the 7520 rate to the remainder beneficiaries without making an additional taxable gift. Additionally, the grantor will have paid any federal income tax liability of the trust from other assets, further leveraging this gifting technique. One option is to structure the GRAT so that the annuity increases up to 20% per year, so that more principal can compound for the benefit of the remainder beneficiaries in earlier years, potentially allowing more property to pass at the expiration of the GRAT term.

Disadvantages

There are no federal estate and gift tax savings if the property underperforms the IRS discount rate or if the grantor dies during the GRAT term. If the grantor dies during the GRAT term, the trust property likely will be included in his or her gross estate for federal estate tax purposes. However, there are no negative tax consequences that result from a failed GRAT. If the GRAT fails, the grantor is no worse off than having done no planning (but for legal and any administrative fees). Therefore, there is little risk in the strategy.

There have been proposals in Congress to change the law so as to make GRATs less favorable from a federal gift tax perspective; however, no such legislation has been passed by Congress, so GRATs remain a viable planning technique. Although successful GRATs can effectively move assets to children, GRATs are inefficient vehicles for mitigating the generation-skipping transfer (GST) tax, an additional layer of tax imposed on transfers to grandchildren or others treated as being two or more generations younger than the transferor. Each taxpayer has an exemption that protects from such tax. GST exemption can only be allocated to a GRAT after the grantor's annuity has been fully paid, and, accordingly, after any growth in value of the trust property has already occurred.

Related Techniques

One technique that is similar to a GRAT is a sale of property to a trust that the grantor is considered to own for income tax purposes (a "grantor trust") in exchange for the trust's promissory note. Another related technique is a Grantor Retained Income Trust (GRIT), in which the grantor retains the right to income from the trust until the earlier of the expiration of a fixed term or the grantor's death. If the grantor outlives the term, any property remaining in the trust may be paid to one or more designated beneficiaries. This technique can be effective only if the remainder beneficiaries are not close family members.

Important Disclosure

Morgan Stanley Smith Barney LLC does not accept appointments nor will it act as a trustee but it will provide access to trust services through an appropriate third-party corporate trustee.

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