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Grantor Retained Annuity Trusts

A Potentially Tax-Efficient Transfer Technique

In the estate planning world, there are dozens of ways to transfer assets to your desired beneficiaries. Some techniques are relatively new and aggressive, while others can be considered "oldies but goodies." One common and longstanding asset transfer technique is a Grantor Retained Annuity Trust (GRAT).

A GRAT is a federally recognized trust arrangement where the grantor/creator of the trust transfers assets to the trust. The trust terms provide that the grantor retains an annuity payment back from the trust of some identified value, and for a term of years (two, four, 10 years, whatever is decided). At the end of the trust term, after the full annuity payments have been made to the grantor, any remaining assets in the GRAT pass to the named trust beneficiaries. In short, a pretty simple set of guidelines.

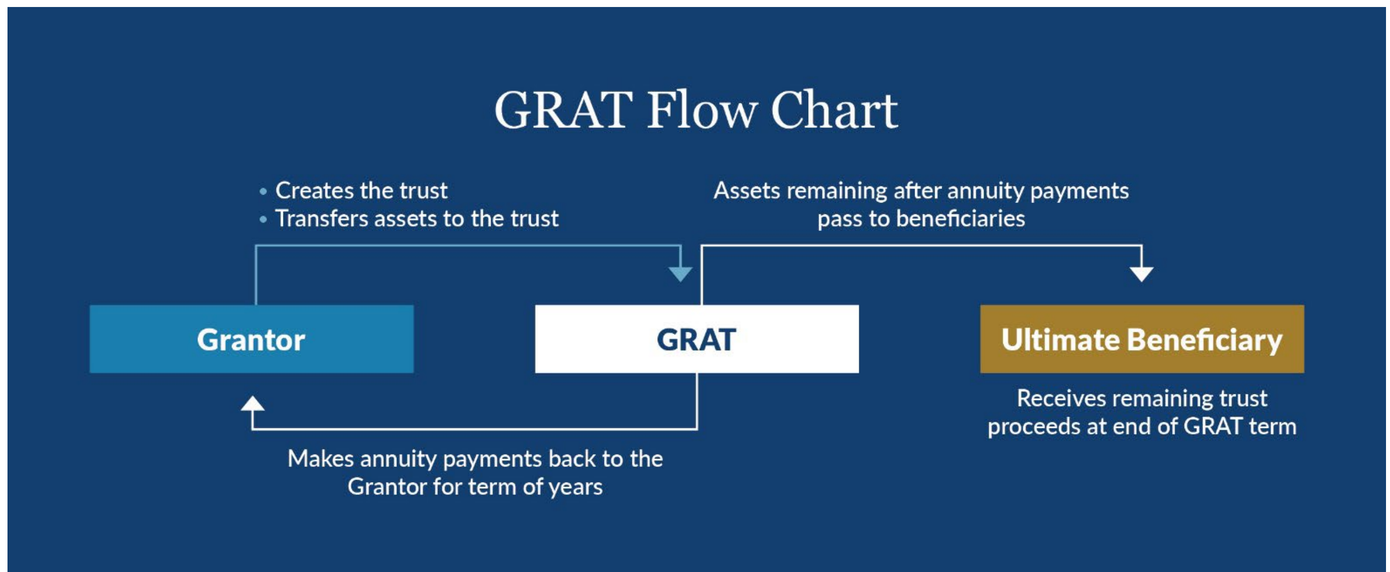
To understand why a GRAT can be a useful asset transfer technique, one must understand the math of a GRAT. At the time a GRAT is created you must calculate the present value of the future annuity payments coming back to the grantor, and the present value of the remainder assets when the trust ends that will pass to the beneficiaries. This calculation is determined by a formula based on a government provided rate of return, called the "7520 rate." Utilizing the calculation, any remainder value expected to pass to the trust beneficiaries is considered a taxable gift. This gift does not qualify for the annual exclusion because it is a gift of a future interest, meaning the gift is taxable.

Let's consider an example. Assume the grantor puts $100,000 worth of assets into the GRAT. Let's also assume the grantor retained an annuity stream that has a present value of $90,000. This calculation leaves us with $10,000 remaining for the GRAT beneficiaries. Consequently, the grantor will have made a $10,000 gift and will have to pay gift tax (or apply the lifetime exclusion amount, currently $13.61 million) on a properly filed federal gift tax return (Form 709) when creating this GRAT.

With this math in mind, it is easier to understand the value of a GRAT. Using our example above, let's assume the contributed assets appreciated greater than the federal government's 7520 rate and instead of $10,000 in the trust when it ends, there is $30,000. Since any tax is calculated and paid at the beginning of the GRAT term, the trust beneficiaries receive $30,000 worth of assets for only a $10,000 gift tax consequence in this example.

In essence, the grantor has "frozen" the value of the gift for gift tax purposes at $10,000, and any growth in excess can pass gift tax-free. However, there is risk in this transaction. If the GRAT performs worse than expected, you may suffer a tax loss, so to speak. Assume at the end of the GRAT only $5,000 remained. In that example the grantor paid $10,000 in gift tax only to actually transfer $5,000.

Accordingly, assets that are expected to grow significantly in value and/or assets that generate a lot of income are prime candidates for GRAT planning. Since the GRAT annuity payments can be made to the grantor "in kind," it's common that closely held business shares, specific stock holdings or other unique assets are used for funding GRATs. In other words, the assets placed in the GRAT do not need to be sold to meet the annuity payment obligations to the grantor.



Because asset growth and income generation can be moving targets, many practitioners create several GRATs that mature over time, sometimes referred to as a "rolling GRAT" plan. For example, they may create one GRAT lasting 10 years, another with an eight-year term, then others with six, four and two-year terms.

This allows each GRAT to be "rolling," so when years of high growth occur and the opportunity to transfer that growth per the GRAT plan materializes, there is always a GRAT vesting to the beneficiaries. It also helps hedge the risk if assets underperform.

Some practitioners work the numbers for the annuity payment so that when you use the government's calculations you have a zero remainder for the trust beneficiaries. These are known as "zeroed out" GRATs. The calculation is more complex than this example, but let's say we're funding a $100,000 GRAT, with an assumed 2.5% rate of return (the 7520 rate), and with annuity payments to be $52,500/year for two years. This could roughly end up with a $100,000 present value for the grantor and a $0 present value for the remainder beneficiaries. Consequently, there is no taxable gift for creating such a trust. But if there are any dollars left over because the trust "outperforms" the expected rate of return, such assets would pass transfer tax-free to the trust beneficiaries.

Consequently, GRATs can be highly effective transfer techniques. In essence, the lower the 7520 rate, the lower the value of the future interest calculation for the remainder beneficiaries. In the past few years, the 7520 rate has been at historic lows, and GRAT usage has increased significantly.

While GRATs may sound like a failsafe plan, GRATs are not without risk. First, there are tax risks. As discussed above, the assets may underperform causing a gift tax "loss." Next, if the grantor dies during the GRAT term, the entire value of the GRAT is pulled back into the grantor's estate for estate tax purposes, thus thwarting any potential transfer tax advantage.

For the zeroed-out GRAT, many proponents say that there is "no risk" because if the assets don't appreciate, you end up back where you started, with no transfer tax consequence. However, there are administrative and legal costs to create and maintain these trusts, constituting an expense beyond the transfer tax concerns.

GRATs are also not effective when transferring assets to "skip" persons given the generation skipping tax (GST) concerns.[1] While too complex to cover here, generally speaking, the amount of GST exemption required to make a GRAT work for skip persons would make such a transfer extremely inefficient. As such, GRATs are rarely used to transfer wealth to multiple generations or to skip people.

[1] A "skip" person is generally someone more than one generation away from the grantor, like grandchildren and more remote descendants. Whenever a gift is made to a skip person there is a secondary transfer tax called the generation skipping tax (GST). The GST exclusion amount for 2024 is $13.61 million (also adjusted for inflation annually). The GST tax rate is 40%, and the GST tax is an additional tax to any previous estate or gift tax liability. Generally speaking, a GRAT requires use of GST exclusion on the entire GRAT value, not just the remainder, meaning such transfers are GST tax-inefficient.

Lastly, the federal government recognizes that the rolling GRAT technique can potentially limit transfer taxes. The government also strictly scrutinizes zeroed-out GRATs. As such, some members of government have proposed a minimum 10-year term for GRATs and have proposed to eliminate zeroed-out GRATs. Should this occur, having a longer term would mean any GRAT technique would have a greater risk of failing should the grantor die during the GRAT term. Moreover, you would need a decade's worth of growth and income to exceed the 7520 rate for the GRAT to outperform. Eliminating the zeroed-out GRAT would mean every GRAT would have a transfer tax consequence.

GRATs can be a highly successful and efficient wealth transfer technique. However, the GRAT's success may only work in appropriate specific situations, and the trust creation and administration can be complex and costly. As such, confer with your tax and legal advisors before considering whether a GRAT is appropriate.

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