Warner Norcross + Judd LLP

GRANTOR RETAINED ANNUITY TRUST

Description

A grantor retained annuity trust ("GRAT") is designed to control growth of the creator's estate by transferring to his or her children appreciation in assets in excess of the growth rates assumed under IRS tables. It might be viewed as a shift of excess growth on a tax-free basis to children. A GRAT is an irrevocable trust that satisfies certain requirements under the Internal Revenue Code. The trust provides for the payment of an annuity for a fixed number of years to the Settlor (Settlor is the creator of the Trust, sometimes called "Grantor" in some documents). The assets given to the GRAT may be used to pay the annuity (*i.e.*, the annuity does not have to be paid in cash). The annuity may be a level amount or an amount that increases by no more than 20% each year. At the end of the annuity term, the remaining assets, if any, are paid to the Settlor's children or to trusts for the Settlor's children.

Planning

A GRAT does not diminish an individual's wealth, since the GRAT will repay to the Settlor through the annuity the value of the assets placed in the GRAT, plus interest.

The Internal Revenue Service monthly publishes an interest rate that must be used to value the annuity (the "IRS rate"). The IRS rate, for the month of creation of the GRAT, also determines the financial performance of the GRAT. The rate for March 2019 is 3.20%.

Only assets with an expected return (income and appreciation) higher than the IRS rate should be given to a GRAT. If the total return on the GRAT assets (income plus appreciation) is greater than the IRS rate, the excess is transferred to children free of gift or estate tax at the end of the Settlor's annuity.

Interest in a closely or family-held business, including S corporation stock, may be placed in a GRAT.

The Settlor may be the Trustee of the GRAT during the annuity term unless certain voting stock is used to fund the GRAT. The Settlor should not be the Trustee for the last three years of the GRAT term if the GRAT is funded with voting stock in a corporation in which the Settlor and certain members of the Settlor's family own 20% or more of the voting control.

Multiple GRATs may be created to minimize the risk of interest rate changes and mortality prior to the end of a GRAT term.

If assets in the GRAT are sold during the term of the GRAT, the Settlor will pay all of the capital gain from the sale of the GRAT assets. In the traditional GRAT, payments from the GRAT to the Settlor do not change. In circumstances where the income tax on GRAT income could be a burden to the Settlor, the GRAT document can include a requirement to distribute to the Settlor amounts required to pay the Settlor's income taxes, but such a clause reduces the performance of the GRAT. Depending upon the Trustee, the GRAT may include other provisions for mandatory or discretionary distributions to the Settlor. These added distributions also decrease GRAT performance.

Tax Attributes

The Settlor will make a taxable gift upon creation of the GRAT. The gift is the value of the assets contributed to the GRAT less the value of the annuity retained by the Settlor. The term of and amount of the annuity should be chosen so that the gift upon creation of the trust is as small as possible. We will review with the client the options available to calculating the size of the gifts to children based upon the current position of the IRS.

The gift does not qualify for the $14,000 annual gift tax exclusion. As a result, the gift will be taxable, but the Settlor can use the lifetime exemption, currently $5,250,000. If the Settlor's lifetime exemption has been applied to prior taxable gifts, then the Settlor must pay a gift tax.

If the Settlor fails to survive until the termination of the annuity, the Settlor's estate must include the value of the assets in the GRAT. Any of the Settlor's unified credit that was used upon creation of the GRAT is restored; if a gift tax was paid upon creation of the GRAT, the estate is credited with the gift tax paid. The estate is in the same position it would have been without the GRAT.

Generally, the Settlor and his or her spouse should not consent to "split gifts" to a GRAT. If the Settlor fails to survive the annuity term, a split gift may result in unnecessary gift or estate taxes for the spouse.

During the annuity term, the GRAT is a "grantor trust" for income tax purposes. This means that the trust is not a separate taxpayer, and all of the trust's income or capital gain during the annuity term is taxed to the Settlor. An income tax return may be required for the GRAT each year.

Generally, grandchildren should not be beneficiaries of a GRAT due to the generation-skipping tax. The assets grandchildren receive produce a generation-skipping tax unless, at the expiration of the Settlor's annuity, the Settlor allocates his or her $5,250,000 GST exemption to the then fair market value of the GRAT assets.

Advantages of a GRAT

Almost any asset may be given to a GRAT. A GRAT shifts appreciation in excess of the IRS rate to children without gift or estate taxation.

In the traditional GRAT, the Settlor's payment of the income tax on the trust's income and gain shifts additional wealth to children (*i.e.*, Settlor must pay the tax on the assets that ultimately pass to children).

The annuity payments may provide a source of assets for $14,000 annual exclusion gifts.

Disadvantages of a GRAT

If the GRAT assets fail to produce a total return greater than the IRS rate, the Settlor's taxable gift at creation of the GRAT will be wasted.

Hard-to-value assets (*i.e.*, real estate, closely or family-held stock, partnership or limited liability company interests) that are used to make annuity payments must be appraised annually.

In the traditional GRAT, the Settlor must be prepared to pay the tax on all of the trust's income or gain without extra distributions from the GRAT, although some flexibility may be inserted with a special tax reimbursement clause.

If a child dies prematurely and has surviving children, the Settlor's estate plan and other assets may have to be used to equalize transfers to the deceased child's children.

The loss of GRAT status for any reason results in a taxable gift of the <u>entire</u> value of assets deposited to the GRAT.