DOWLING & YAHNKE
WEALTH ADVISORS

WHAT IS A GRANTOR RETAINED ANNUITY TRUST (GRAT)?

A GRAT is an irrevocable trust that allows the owner of an asset (or group of assets) to potentially pass along growth from the asset to beneficiaries while using a minimal amount of their lifetime gift or estate tax exemptions. Especially in a low interest rate environment, a GRAT can be a very valuable tool for transferring growth from appreciating assets to heirs.

Initially, the grantor places an asset or group of assets into a GRAT. Then, the grantor receives annuity payments from the GRAT for a set number of years. The annuity payment is comprised of a principal component plus an interest component determined using the IRS Section 7520 rate. The annuity payments from the GRAT can be in the form of cash, other assets, or a combination thereof. After the GRAT term has elapsed, if the grantor is still living, the remaining assets in the GRAT are transferred to the trust beneficiaries, potentially free of gift and estate tax.

TAXATION OF GRATS

- Income Taxes: During the term of the GRAT, the grantor retains the responsibility to pay taxes on income and gains earned within the trust. The GRAT is a grantor trust and therefore the interest component of the annuity is "disregarded" for income tax purposes.

- Gift Taxes: When the GRAT is created, the value of the taxable "gift" is equal to the fair market value of the assets placed in the trust less the present value of the annuity payments to be received from the trust.

  The present value of the annuity payments is calculated using the IRS Section 7520 rate (0.4% on an annual basis for October 2020). Some grantors may choose to use a "zeroed-out GRAT" in which the present value of the annuity payments is set equal to the fair market value of the asset, eliminating any gift tax consequences.

- Estate Taxes: If the grantor outlives the term of the GRAT, no estate or gift tax will be due on any remaining assets in the GRAT that are transferred to the beneficiaries. If the grantor dies during the GRAT term, any remaining assets in the GRAT will be included in the grantor's gross estate. To mitigate this risk, some grantors use short-term and/or rolling GRATS, a laddered strategy in which successive GRATs are funded with previous GRAT annuity payments.

- Generation Skipping Transfer Tax: It is important to select beneficiaries carefully so as not to incur generation skipping transfer tax. GRAT beneficiaries are therefore generally children, not grandchildren.

EXAMPLE

Marilyn founded a toy company many years ago that has been very successful. As a majority owner, she currently holds five million shares valued at $25M ($5/share). The company is planning an IPO. Let's assume the stock will grow 10% per year for the next five years.

Marilyn would like to pass her shares to her daughter, Evelyn. In this example, we assume that Marilyn passes away in five years, right after the expiration of the GRAT. Marilyn has already used her lifetime estate tax exemption amount and intends to use her annual gift tax exclusion amount with annual gifts of cash to Evelyn.

If Marilyn does not elect to utilize a GRAT, the value of the shares will grow from $25M to $40.3M (10% compound annual growth) at the end of the five years. At Marilyn's death in five years, Evelyn would receive $24.2M in inheritance after paying 40% federal estate taxes.

If Marilyn instead uses a GRAT, Marilyn's estate will save $3.7M in taxes based upon the remainder value of the GRAT at its expiration. Let us take a closer look at how this is accomplished:

Step 1: Establishing the GRAT

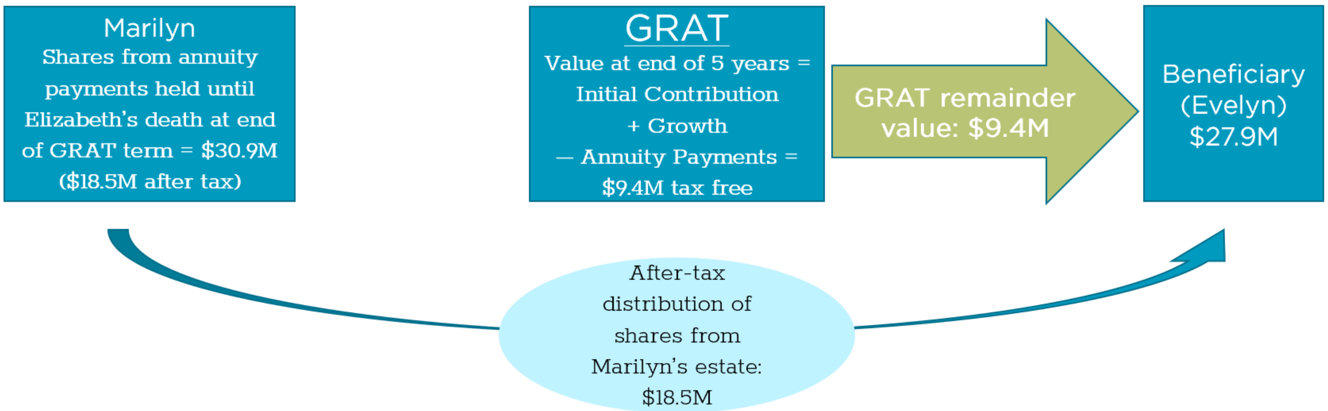
Before the IPO, Marilyn places all the shares into a five-year GRAT for Evelyn.

Step 2: Annuity payments

Based on the October 2020 Section 7520 rate of 0.4%, Marilyn will receive $5.1M in annuity payments each year for five years. The present value of those annuity payments is $24,999,775. Marilyn, therefore, effectively pays no gift tax on the gift to Evelyn since the value of the annuity payments is nearly equal to the fair market value of the shares transferred into the GRAT.

Step 3: End of the GRAT's term

After five years, the term of the GRAT is reached and, in this example, the Grantor (Marilyn) has died. The remaining assets within the GRAT have appreciated to $9.4M which pass free of gift and estate tax to Evelyn. Additionally, the value of the shares received in the form of annuity payments in Marilyn's estate at the end of the five years is $30.9M, which will be subject to estate taxes, leaving $18.5M after-tax to Evelyn. Therefore, the total after tax assets received by Evelyn would be $27.9M.



When compared to the traditional option of passing the securities at Marilyn's death of $24.2M, the GRAT structure saved Evelyn $3.7M in taxes.[1] This highlights the value of a GRAT if a grantor is willing to relinquish control of assets during her lifetime to pass along greater amounts to her beneficiaries.

It is also important to note that the magnitude of the GRAT remainder value is directly tied to the level of growth of the assets in the GRAT. Therefore, funding a GRAT with assets that appreciate faster than the Section 7520 rate is ideal from a planning perspective. The following chart demonstrates the different GRAT remainder values by varying the annual growth of the shares of Marilyn's toy company:

Annual Return	GRAT Remainder Value
0.4% (section 7520 rate)	$229
2%	$1,268,983
5%	$3,946,714
10% (example growth rate)	$9,370,247
15%	$16,166,711

[1] GRAT annuity payments and remainder value calculated on rogerhealy.com

If you think a GRAT may be a useful tool for you to pass along more assets to your beneficiaries, Dowling & Yahnke Wealth Advisors would be happy to talk to you, your tax professional, and estate planning attorney to discuss the risks and potential benefits.

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