

Your Money

Are GRATs great vehicle to reduce or eliminate estate taxes?

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What is a Grantor Retained Annuity Trust (GRAT) and is it a great vehicle to reduce or eliminate our estate taxes?

The problem? Estate taxes. Estates larger than \$3.5 million pay federal estate taxes of up to 45%. Estates larger than \$675,000 pay New Jersey state estate taxes of up to 16%. That could add up to a 61% tax rate and millions of dollars of tax payments.

The solution? A GRAT. Fortunately, a number of estate planning vehicles exist to reduce or eliminate estate taxes. The Grantor Retained Annuity Trust (GRAT) is one great vehicle that could eliminate estate taxes by transferring assets out of your estate. While low interest rate environments, like the one we are in now, present certain challenges, they can enhance the benefits of GRATs.

Why establish a GRAT? A GRAT is an irrevocable trust created by a person (the "grantor"), who transfers assets into the trust and receives a stream of annuity payments from the trust for a specified term. At the end of the term the remaining assets of the GRAT are distributed to the named beneficiary (the "remainderman") or placed into a trust for the benefit of the beneficiary. The grantor can avoid gift taxes from transfers if the GRAT is "zeroed out." Translation: the full amount transferred in is paid back to the grantor.

The minimum stream of payments for the term of the trust is determined by the Internal Revenue Code 7520 Interest Rate, oftentimes called a "hurdle rate." The current rate of 3.2% is significantly lower than the 6.2% rate as recent as August of 2006, making the GRAT more appealing now than in many periods over the last 10 years. The primary reason for establishing a GRAT is to remove net profits from the estate, with net profits defined as any excess return above the hurdle rate. The lower the hurdle rate, the easier it is to remove more assets from your estate. Translation: it is easier to earn more than 3.2% than it is to earn more than 6.2%.

A great example of a GRAT: Marc, the grantor, transfers \$1 million to a GRAT that names his son Ryan the beneficiary, with a 10-year term. Marc avoids gift taxes on the \$1 million transfer by receiving the minimum required 3.2% annuity each year and the return of his \$1 million. Fortunately, the GRAT value at the end of the term was \$2.2 million, net of taxes. At the end of the term, Ryan receives the remaining value of \$1.2 million (\$2.2 million - \$1 million) tax free, while Marc removes \$1.2 million of assets from his estate, gift and estate tax free.

What happens if the grantor dies before the GRAT terminates? If the grantor dies before the term of the GRAT the entire transfer is added back to the grantor's estate. This defeats the purpose of the GRAT and is a key reason to consider rolling GRATs.

Rolling GRATs commence immediately after the preceding GRAT matured. They are primarily utilized to avoid two problems: 1) locking in a too-high hurdle rate in a declining hurdle rate environment and 2) the penalty associated with a death of the grantor over the course of too long a term.

Action step: Establish a GRAT. Hurdle rates are unlikely to remain this low for very long. Establishing a GRAT now, when hurdle rates are low, increases the likelihood you will be able to remove a larger amount of assets from your estate – potentially eliminating your federal and state estate tax obligations. The earlier you establish a GRAT, the greater the potential benefit. Establishing an estate plan with the expertise of your financial adviser and estate attorney can be one of the best investments of your life. **RW**

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