A Powerful Way to Plan: The Grantor Retained Annuity Trust

According to The Taxpayer Relief Act of 2010, the estate and gift exemption amount has been increased temporarily, for 2011 and 2012, to $5 million per person and the top transfer tax rate has been reduced to 35%. In addition, all federal transfer taxes—including the estate, gift, and Generation Skipping Transfer (GST) taxes—have been reunified, such that the rate and exemptions are all equivalent at these levels. In addition, individuals may contain to make gifts during the year to designated beneficiaries. It is important to keep in mind, however, that these changes are temporary; they are set to expire at the end of 2012, and will need to be revisited by Congress prior to the end of 2012. By leveraging the applicable lifetime gift-tax exclusion, a Grantor Retained Annuity Trust (“GRAT”) can present a significant estate-tax savings opportunity for high-net-worth individuals.
The Grantor Retained Annuity Trust

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**GRANTOR RETAINED ANNUITY TRUST**

A Grantor Retained Annuity Trust is an estate planning technique whereby an individual makes an irrevocable gift of assets to a trust, while retaining an income stream from the trust for either an established term of years, or the shorter of the term of years or life. This arrangement is sometimes called a “split interest” trust, referring to the two types of interests that comprise a GRAT: a retained interest, which the grantor receives from the trust in the form of an annuity; and a remainder interest, which the named beneficiary receives at the termination of the trust. The annuity is a fixed amount determined at the inception of the trust and paid out to the grantor at least annually.²

**GIFT-TAX CONSEQUENCES**

The value of the taxable gift to a GRAT is determined at the inception of the trust. The value is arrived at by reducing the fair market value of assets transferred to the GRAT by the amount of the grantor’s retained interest. Thus, the taxable gift to a GRAT is always less than the fair market value of the assets used to fund the trust.³ The larger the retained interest, the smaller the taxable gift, and in some cases, the taxable gift may be very close to zero.⁴

In many instances, taxes owed on the gift to a GRAT can be partially or fully offset by the grantor’s applicable lifetime gift-tax exclusion amount. Section 7520 of the Internal Revenue Code provides guidelines for the valuation of the retained interest in a GRAT and defines the interest rate to be used in such valuation, commonly referred to as the Section 7520 rate.⁵ When a GRAT is created for the shorter of a term of years or life, the retained interest is determined by an actuarial calculation that takes into account the present value of the annuity that the grantor will receive from the trust, the Section 7520 prescribed growth rate for the month in which the GRAT is created, the grantor’s age when there is a life contingency and any reversionary interest.⁶

**ESTATE-TAX CONSEQUENCES**

Generally, when an individual gifts an asset, but retains the right to benefit from it during his/her lifetime, all or a portion of the asset gifted will be returned to the estate at its fair market value at the time of the individual’s death for the purpose of calculating federal estate tax. For this reason, the grantor of a GRAT must survive the trust term in order to have trust assets completely escape estate taxation. If the grantor dies during the term of the GRAT, the portion of the trust balance needed to generate the remaining annuity payments will be brought back into the grantor’s estate and any gift taxes paid will be credited against the estate taxes due.

If the grantor outlives the GRAT term, assets remaining in the trust will pass to the named beneficiaries according to the terms of the GRAT. The result is that any appreciation that occurs in the trust in excess of the Section 7520 rate used to initially value the retained interest is transferred to the beneficiaries with no additional gift, which results in significant gift-tax savings to the grantor.⁷ Consider the following example:
A 55-year-old investor has accumulated a stock portfolio that she would like to transfer to her two children at some point in the future. The investor gifts the $2 million stock portfolio to a 10-year GRAT and retains an annuity of 5% (or $100,000 per year). Using the Section 7520 rate of 3.0% for April 2011, the investor's retained interest would be valued at $853,020 based on an actuarial calculation. The taxable gift, that is, the market value of the assets transferred to the GRAT, reduced by the investor's retained interest, is equal to $1,146,980. Assuming that this investor has not made any taxable gifts in the past, her entire gift-tax payable pursuant to the terms of the GRAT will be offset by the federal gift-tax credit available to her by her applicable gift-tax exclusion amount. If the assets grow at a hypothetical after-tax rate of 8% per year at the end of the 10-year GRAT term, the investor's beneficiaries will receive $2,869,194 gift-tax free and the grantor will not have paid any gift taxes out of pocket and only used a portion of her gift-tax exclusion amount. In the event of the investor's premature death, a portion of the benefit from the GRAT will be lost, but she may not be worse off than if she had not created the GRAT at all. Her risk in the first year of the GRAT will be limited to the fees and expenses incurred to create the trust. Her risk in succeeding years will continually decrease.
“ZEROED OUT” GRAT
A “zeroed out” GRAT is a strategy that refers to a GRAT whereby the grantor’s retained interest is very close in value to the market value of assets transferred to the trust and their projected growth rate prescribed by Section 7520, thus reducing the taxable gift to almost zero. All appreciation in excess of what is required to make the annual annuity payment to the grantor during the term of the trust, is passed to the remainder beneficiaries free of gift taxes. A “zeroed out” GRAT works best when the assets funding the trust appreciate significantly. Since only a small taxable gift is made at the inception of the trust, even if trust assets do not appreciate, the downside is limited to any gift taxes paid (or gift-tax exclusion amount used up) as well as the fees and expenses that were incurred to set up the trust. Federal gift-tax savings are potentially unlimited since all appreciation in excess of what is required to pay the grantor’s annuity is transferred to remainder beneficiaries gift-tax free.

WHY CREATE A GRAT NOW?
Low Section 7520 rates have created a favorable environment for GRATs. An inverse relationship exists between the interest rate used to discount the annuity in a GRAT, and the valuation of the retained interest. As the Section 7520 rate falls, the present value of the retained interest rises, and the remainder interest falls. Therefore, the taxable gift will be smaller when the Section 7520 rate is relatively low, making it more attractive to fund a GRAT. To produce a favorable result in a GRAT, trust principal must appreciate at least as rapidly as the Section 7520 rate in effect at the inception of the trust. When the Section 7520 rate is low, the grantor’s dollars simply need to outperform the Section 7520 rate, for the GRAT to be successful.

 INCOME TAX CONSIDERATIONS
For income tax purposes, GRATs are usually treated as grantor trusts, which means that the grantor will be liable for taxes on income earned by the trust. While this requires that the grantor have sufficient cash flow to meet potential income tax liability, it can further facilitate the reduction of the grantor’s estate by, in effect, making an additional gift to the beneficiaries of the GRAT and preserving the assets in the GRAT for the remainder beneficiaries.

Currently, assets included in the decedent’s estate receive a step-up in cost basis. Lifetime gifts are not eligible for the step-up in cost basis and beneficiaries of a GRAT will retain the original cost basis of the grantor. To limit the capital gains tax exposure for the beneficiaries, a GRAT may be funded with high-cost-basis assets or low-cost-basis assets that are sold during the GRAT term to either the grantor or an outside party.

PLANNING CONSIDERATIONS
Minimizing Payment of Gift Taxes
Given the degree of uncertainty surrounding the future of the federal estate tax, it is beneficial to leverage the applicable lifetime gift-tax exclusion amount and minimize the current payment of gift taxes in the event the higher estate and gift exempt amount are not extended beyond 2012.
The Grantor Retained Annuity Trust

**Selecting Assets**
Income-producing and highly appreciating assets yield the most benefit when transferred to a GRAT. Appreciation in excess of what is required to pay a grantor’s annuity is transferred to remainder beneficiaries on a gift-tax-free basis. At the same time, sufficient income needs to be available in order to meet the required distributions to the grantor without liquidating the trust principal. While a variety of assets may be used to fund a GRAT, careful consideration needs to be given to potential income tax consequences.

**Choosing the Trust Term**
A longer GRAT term not only increases the grantor’s retained interest, but also provides a longer investment horizon for the trust’s assets to appreciate. However, it is important to remember that if the grantor dies during the trust term, a portion of the GRAT will be included in the estate. Note though if the grantor’s death does occur during the term of the current tax law, the portion of the trust brought back into the grantor’s gross estate may be sheltered, at least partially, by the possibility of an increasing estate-tax exemption amount after 2010.

**Reducing Mortality Risk with Life Insurance**
The risk of the grantor’s premature death, subjecting a portion of the GRAT balance to future estate taxes, can be hedged by purchasing life insurance. The grantor can fund an irrevocable life insurance trust (“ILIT”), which will purchase a life insurance policy on the grantor’s life. A policy purchased and owned in an ILIT should pass outside the grantor’s estate. In the event of the grantor’s death prior to the termination of the GRAT, the death proceeds from the policy can be used to provide liquidity for the grantor’s estate or replace any benefits lost to the GRAT beneficiaries. If the grantor chooses to fund an ILIT, the premiums paid will be considered a gift to the beneficiaries of the life insurance trust.

**Using a Trust After GRAT Term Expires**
After expiration of the GRAT term, assets do not need to pass outright to the remainder beneficiaries. They can remain in a trust, where they will be professionally managed and distributed to the beneficiaries in accordance with the terms of the trust document. A trust can also help protect assets from creditors of the beneficiary.

While a GRAT may work well for some individuals, it is not for everyone. Gifting an asset to a GRAT means irrevocably giving up control over the asset and losing any other possible benefits from the asset gifted, other than the retained annuity. Only persons who have sufficient assets and income, and are willing to irrevocably gift the assets to the next generation, should consider a GRAT.

Tax savings are not always the primary estate planning objective. Preservation and enjoyment of an asset during a person’s lifetime may take priority over wealth transfer planning. The balance between saving on taxes and retaining control of an asset should be carefully weighted prior to making any irrevocable transfers. Each planning technique must be considered as part of the overall estate and financial plan.
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1 There is an annual exclusion of $13,000 per donor, per recipient, which will not count against the applicable lifetime gift-tax exclusion amount. Annual exclusion is indexed for inflation in increments of $1,000.

2 Grantor Retained Unitrust ("GRUT") is a technique similar in structure to the GRAT. In a GRUT, the retained income is a fixed percentage of the trust balance recalculated annually. Because a GRUT will always distribute some of the trust appreciation back to the grantor, GRUTs are considered to be less effective in leveraging the gift-tax exclusion than GRATs and are therefore less popular techniques for estate planning.

3 Clients create GRATs using assets that are likely to earn more than the Internal Revenue Service's measuring standard (the Section 7520 interest rate) during the GRAT term in an effort to pass the appreciation in the assets to the beneficiaries of the trust free of gift and estate tax.

4 The Treasury regulations require that the trust instrument contain a provision requiring adjustment to annuity payments previously made if an error was made by the trustee in determining the annuity amount.

5 Section 7520 rate is equal to 120% of the Applicable Federal Midterm rate, published monthly by the U.S. Treasury Department. Section 7520 sets the rate to be used for valuing annuities, life interests or interests for a term of years and remainder and reversionary interests.

6 An example of a reversionary interest is a provision that would require assets to revert back to the grantor's estate in the event the grantor's death occurs during the term of the trust. Such a provision may cause the trust assets to be distributed according to the grantor's will and not pass to the remainder beneficiaries named in the trust document. Reversionary interests may further increase the value of the retained interest and reduce the value of the taxable gift. Special rules apply to transfers of interest to family members. IRC Section 2702 requires that when family members are involved, any retained interest, other than a "qualified" annuity or unitrust interest, is assigned a value of zero for the purpose of calculating the taxable gift.

7 If the grantor dies during the GRAT term and the right to the remaining annuity payments passes to a surviving spouse, in order to ensure that the value of the remaining annuity interest qualifies for the estate-tax marital deduction under Section 2056, the grantor’s estate planning documents should provide that if the grantor’s spouse survives the grantor, the annuity payments will either (1) pass outright to the surviving spouse or her estate or (2) pass to a marital trust over which the spouse has a general power of appointment.

8 Source: Revenue Ruling 2008-20 Table 5.

9 Calculation is based on the shorter of term of years or life and is computed with the help of Number Cruncher software.

10 The Tax Payer Relief Act of 2010 provided for the return a step-up in cost basis for all non-qualified plan, annuity assets.

11 Individuals must show evidence of insurability since life insurance may not be available to all individuals due to pre-existing health conditions or age limitations. Morgan Stanley Smith Barney LLC and its affiliates do not provide tax or legal advice. To the extent that this material or any attachment concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Any such taxpayer should seek advice based on the taxpayer’s particular circumstances from an independent tax advisor.