Consider a GRAT to Transfer a Business

Succession planning for your business can be daunting. Along with selecting the right family member or other individual to carry on the business, you must weigh a variety of tax and financial planning issues. Some closely held business owners have found it pays to use a grantor retained annuity trust (“GRAT”).

A GRAT can help you minimize gift and estate tax liability associated with transferring ownership interests while retaining an income stream for a specified period of time. And it may be particularly powerful in the current economic environment, where the lifetime gift tax exemption is high and the value of your business may be lower than it was a few years ago.

The Nuts and the Bolts

A GRAT is an irrevocable trust funded by a one-time contribution of assets by the "grantor." For example, if you're the owner of a real estate development company, you can transfer some or all of your ownership interests in the business to the GRAT. The GRAT pays you, as the grantor, an annuity for a specific term.

The amount of the annuity payment is a fixed percentage of the initial contribution's value or a fixed dollar amount; either way, the payment must be made at least annually. You maintain the right to the payments regardless of how much income the trust actually produces.

When the GRAT's term expires, the assets remaining in the trust (known as the "remainder") transfer to designated beneficiaries. But your gift tax is assessed when the GRAT is funded, based on the value of the beneficiaries' remainder interest.

The remainder interest's value hinges in part on an IRS interest rate, known as the Section 7520 rate, at the time of the GRAT's creation. An asset such as an ownership interest in a closely held real estate business must undergo a valuation before the Section 7520 rate can be applied to calculate the remainder interest's value.

If the Section 7520 rate is low (as it has been recently) and the trust assets can generate a higher rate of return, the assets will be worth more when the trust terminates than the remainder interest's gift tax value. So, the excess asset appreciation over the term of the trust passes to the beneficiaries free of gift and estate taxes.

In addition, with the lifetime gift tax exemption set at $5.60 million for 2018 your gift tax obligation when funding a GRAT may be significantly lower than it would have been in the past (in 2017 the exemption was $5.49 million).

Furthermore, if your business's value is currently lower than it has been, the interests will have a lower value for gift tax purposes. And GRATs work particularly well with interests in closely held businesses because valuation discounts can reduce a gift's value for tax purposes even more.

You must report the income, gains and losses from the trust assets on your individual income tax return. Paying income tax on the trust asset income and gains is actually beneficial for estate planning purposes. Why? By you paying the tax (rather than the GRAT paying them), you're preserving the trust's assets for the beneficiaries — essentially making additional tax-free gifts to them — and further reducing the size of your taxable estate.

IRS Rules

While the IRS accepts GRATs as valid vehicles for transferring assets, it does impose some rules on the trust instrument used to create a GRAT. The instrument must prohibit:

- Additional contributions to the GRAT;
- Commutation (prepayment of the grantor's annuity interest by the trustee); and
- Payments to benefit anyone other than the grantor before the grantor's retained interest expires.

Moreover, issuing a note, other debt instrument, option or similar financial arrangement to satisfy the annuity obligation is not allowed.

Don't Wait

If a GRAT sounds right for you, now is the time to contact your estate planning advisor. First, you can potentially take advantage of a low business value, a low Section 7520 rate and a high gift tax exemption.

Second, Congress has introduced several bills that would limit the benefits of GRATs by, for example, requiring a minimum term of 10 years. Why does the term of the GRAT make a difference?

If the grantor doesn't survive to the end of the GRAT term, the gift is effectively "undone" for tax purposes, and the GRAT assets are included in the grantor's estate at their current value. The benefit of transferring the appreciation out of the grantor's estate will be lost. It's likely that any successful legislation would apply only *prospectively*, though, leaving existing GRATs intact.

An Alphabet Soup of Trusts

GRATs aren't the only type of grantor trusts available for estate planning. You might also want to consider a grantor retained unitrust (“GRUT”) or grantor retained income trust (“GRIT”). Like a GRAT, both are irrevocable trusts created by the transfer of assets and followed by the gift of remainder interests, but there are some key differences.

When you create a GRUT, you retain an annual right to receive a fixed percentage of the net fair market value (FMV) of the trust assets, as determined on an annual basis, for a specified term. If the FMV increases, the amount of your payment also increases. Just as with a GRAT, if you survive the term, the remaining value of the trust passes to the named beneficiaries.

With a GRIT, you retain the right to receive all of the income the trust generates for either (1) the earlier of a specified term or at your death, or (2) a specified term. If you outlive the specified term, any principal left in the trust passes to the beneficiaries named in the trust instrument. However, the beneficiaries can't be members of your family (e.g., children), but nieces and nephews and more remote family members would qualify.

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