

GRATS: A Perfect Storm

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The current crazy economic environment has created a "Perfect Storm" for affluent investors seeking to transfer assets to the next generation with minimal gift or estate taxes. How? Through the strategic use of Grantor Retained Annuity Trusts, or GRATs.

A GRAT is a trust containing certain IRS restrictions that allows assets to potentially be gifted to heirs at a fraction of their value in return for the grantors right to receive annuity payments for a period of time.

What's the recipe for the "perfect storm"? Combine lower stock prices with low interest rates and record-low Applicable Federal Rates (AFRs) for an unprecedented opportunity for long-term, risk-averse growth.

On the flip side, if the market is overvalued and interest rates and AFR are too high, there really is no downside other than the cost and effort to set it up.

How Do GRATs work?

GRATS leverage fixed annuities for a fixed number of years – 1, 3, 5 or more – providing a unique way to transfer the fair market value of assets on a discounted basis, since only part of the gift gets valued in the irrevocable trust. (Other forms of trusts, including charitable lead trusts, grantor retained income trusts (GRITS) etc., are variations of this concept.)

The annuity payout and remainder interest vary with the length of time for which the GRAT is established. The value of what's left for heirs, for gift tax purposes, is calculated by subtracting from the trusts' value the discounted present value of one's annuity. The AFR, or discount rate (aka the Section 7520 rate) stems from a formula based on Treasury Note yields. Right now, Treasury yields are at record lows. If assets earn more than the discount rate, you'll receive a break on gift taxes.

The Ideal Profile

So who should consider GRATs?

If you're a corporate executive with a single stock concentration, especially in the current market environment, GRATs are a perfect hedge for volatility in a portfolio. While normally Rule 144 does not come into play, as you are keeping the stock closely held, the use of a GRAT and its implications must be reviewed with corporate council prior to implementation.

For an entrepreneur with closely-held stock, GRATs may be an effective tool for succession planning, and wealth transfer. Often there are opportunities to receive beneficial valuations on privately held stock since there is not a ready public market for the securities.