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Grantor-Retained Annuity Trust works well with stocks

This article is Part 4 of a series exploring the various types of trusts that may benefit your clients. Today's topic is Grantor-Retained Annuity Trusts (GRAT).

Do your clients own stock, especially stock in a start-up company? If so, a Grantor-Retained Annuity Trust might be right for them.

The GRAT is an irrevocable trust that transfers wealth without paying gift or estate taxes. Say for example your clients put stock in a trust that pays them an annuity for a set number of years, generally two to five. The remainder goes to their beneficiaries in the form of a gift.

GRATs can help your clients transfer the appreciation of an asset, above a currently small interest rate, to a beneficiary tax-free. Their power comes in having a duration as short as two years.

Famous examples

Facebook founders Mark Zuckerberg and Dustin Moskovitz put pre-IPO stock in to GRATs for children they didn't yet have. William Wang, founder and majority owner of HDTV-maker Vizio, set up two GRATs, each with 450,000 shares; he's the trustee of one, and his wife runs the other.

The key for your clients is to pick stocks that are about to increase in value. (Easier said than done, of course.)

Federal rules

The Internal Revenue Service values your clients' gift to their beneficiaries based on the size of the annuity your clients take back and the rate of return the trust is expected to earn during its term. The rate, known as the 7520 rate, is 120 percent of the federal midterm rate, and in August 2018, the midterm rate was 3.4.

A popular GRAT variant is the "zeroed-out" or Walton GRAT (in honor of Audrey Walton, ex-wife of Wal-Mart cofounder Bud Walton, who won a court case that makes this plan possible).

To use this, your clients should set the annuity so that it equals their original contribution to the GRAT, plus earnings at the 7520 rate, reducing the taxable value of the gift to their beneficiaries to $0. Any appreciation of the stock above the 7520 rate is transferred to their beneficiaries without eating into their lifetime exemption from estate and gift taxes.

Drawbacks

Assets that are expected to appreciate greatly in value can be transferred into a GRAT and in turn move a significant amount of property down to your clients' beneficiaries when the term ends. There are, however, downsides to using a GRAT:

- The assets transferred into the GRAT could grow at a rate lower than the section 7520 rate. If this is the case, then your grantor client will simply receive back the trust property at its depreciated value.
- Your client could die during the term of the GRAT, and if this happens, all of the property transferred into the GRAT would revert back into the estate of the grantor - and be taxable for estate tax purposes.

Another good planning approach is to create separate GRATs for each asset. If your client combines two or more unstable assets into one GRAT, then the losses on one might offset the gains on another.

A well-designed GRAT is a powerful way to avoid gift-tax consequences while providing your client's family a significant portion of an asset's income.

We hope this information is useful to you and helps your clients and their families. If you have a specific case or question, please don't hesitate to call our office.