

Abstract: A grantor retained annuity trust (GRAT) lets taxpayers generate income for themselves while potentially removing significant amounts of wealth from their estate at a relatively low gift-tax cost. A zeroed-out GRAT allows them to eliminate gift taxes altogether. This article explores when to consider a zeroed-out GRAT.

Zero in on tax savings with a “zeroed-out” GRAT

A grantor retained annuity trust (GRAT) is a powerful tool for reducing gift and estate taxes. It lets you generate income for yourself while potentially removing significant amounts of wealth from your estate at a relatively low gift-tax cost. And you may even be able to use a “zeroed-out” GRAT to eliminate gift taxes altogether.

How do GRATs save estate tax?

To take advantage of a GRAT, you make a one-time contribution of assets to an irrevocable trust. The trust pays you an annuity for a specified term, and at the term’s end any remaining assets are transferred tax-free to your children or other beneficiaries. The annuity can be stated as a fixed percentage of your initial contribution’s value or a fixed dollar amount.

GRATs allow you to avoid estate taxes by removing assets from your estate if you outlive the GRAT’s term. (Note that, although an estate tax repeal went into effect Jan. 1, 2010, the estate tax is scheduled to return in 2011. Congress may even take action to repeal the repeal, perhaps retroactively to Jan. 1. Check with your tax advisor for the latest information.)

A GRAT can be particularly effective for assets that you expect to appreciate rapidly or that produce substantial amounts of income. Why? Because future earnings and appreciation on GRAT assets in excess of the IRS’s assumed rate of return (the Section 7520 rate) are shielded from gift and estate taxes. (You’ll be responsible for reporting the trust’s income on your individual income tax return, though.)

How do GRATs save gift tax?

While the initial transfer of assets to a GRAT is a taxable gift, you can minimize or even eliminate gift taxes depending on how you structure the trust. For gift tax purposes, the gift to your beneficiaries is the residual assets they’re expected to receive at the end of the trust term.

To calculate the gift’s value, the fair market value of the assets you contribute to the GRAT is reduced by the actuarial value of the annuity, which is based on IRS tables that incorporate the Sec. 7520 rate. If the trust assets outperform the Sec. 7520 rate, the beneficiaries enjoy a tax-free windfall.

By increasing the trust term or the annuity payments, you can shrink the residual value, thereby reducing the gift tax. But selecting a trust term that is too long can

backfire because the assets will be included in your taxable estate if you don't outlive the trust.

For example, Monica is 55. She transferred \$1 million in assets to a GRAT that paid her an annuity of \$100,000 per year for the shorter of her life or 10 years. At the end of the 10-year term, the residual assets go to Monica's son, Billy. The Sec. 7520 rate in effect when Monica established the GRAT was 4.6%, but the trust's assets earn an actual return of 8%.

According to IRS tables, the value of Monica's gift to Billy was approximately \$248,400. But Billy's actual residual interest, based on the 8% rate of return, is \$710,269. Monica received annuity payments totaling \$1 million over 10 years, while removing more than \$700,000 from her estate. Assuming Monica has at least \$250,000 of her \$1 million lifetime gift tax exemption still available, the entire transaction is gift-tax free.

When should you consider a zeroed-out GRAT?

If your estate is relatively small and you haven't used up your lifetime gift tax exemption, an ordinary GRAT is likely your best bet. It may allow you to transfer substantial amounts of wealth to your family free of gift and estate taxes, while retaining a healthy income stream. But in so doing, you'll be required to use all or a portion of your gift tax exemption.

If you've already used up your gift tax exemption, a zeroed-out GRAT may be an attractive option. Why? Because it may allow you to achieve the same tax benefits as afforded by an ordinary GRAT, but without any gift tax consequences.

Suppose that, in our example, Monica received annuity payments of \$127,000 per year, and the GRAT was designed so that, if Monica failed to survive the trust term, the remaining annuity payments would be made to her estate (a requirement for a zeroed-out GRAT to work). Based on the IRS tables, the annuity's present value was \$999,998, resulting in a taxable gift of only \$2.

Keep in mind that zeroed-out GRATs have a downside: Boosting the annuity payments reduces the amount of wealth you remove from your estate. In our example, shifting to a zeroed-out GRAT lowers the amount Billy receives from the trust to about \$320,000.

Which GRAT is right for you?

To determine the appropriate structure for a GRAT, you need to review your estate planning goals and circumstances. Then strike a balance between your interest in reducing gift and estate taxes and your interest in making lifetime transfers to beneficiaries.