

Grantor Retained Annuity Trusts in a Low Interest Rate Environment Can Be a Valuable Estate Planning Tool

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On December 16, 2015, the Federal Reserve announced its decision to raise the benchmark interest rate, for the first time since 2008's financial crisis, to a range of between 0.25 – 0.5%. With IRS statutory rates still low, from an estate planning perspective, the current rate environment continues to foster advantageous wealth transfer opportunities.

The IRS applies the applicable federal rate (AFR) and the IRC Section 7520 rate to value the interests of many types of planned gifts, including annuities, life interests, and remainder and reversionary trusts. The recently released IRS rates for January 2016 are an AFR of 1.81% (for loans of three to nine years) and a Section 7520 discount rate of 2.2%. Therefore, to the extent an investment can generate returns that are greater than the AFR or the Section 7520 rate, there may be opportunities to transfer those excess returns to next generation beneficiaries free of transfer taxes.

A Grantor Retained Annuity Trust (GRAT) is a relatively simple way to take advantage of the low Section 7520 rate. A GRAT is an irrevocable trust to which a grantor transfers assets while retaining the right to receive an annuity, which is paid annually for a fixed term of years. At the end of the annuity period, any property remaining in the GRAT passes to the ultimate beneficiaries of the trust, either in further trust or outright, depending on the grantor's preferences.

A properly structured GRAT passes the appreciation in transferred property in excess of the Section 7520 rate to beneficiaries at a minimal or zero gift tax cost. This is because the IRS assumes that the assets in a GRAT will grow at the Section 7520 rate in effect at the time the GRAT is created and funded, and does not consider the actual growth of the assets. Therefore, appreciation in excess of the Section 7520 rate can be passed on to the ultimate beneficiaries free of gift and estate tax. GRATs present excellent opportunities in a low interest rate environment because it is easier to outperform the Section 7520 rate than in a high interest rate environment, resulting in a larger potential tax free gift.

If the grantor survives the annuity period of the GRAT, the remaining assets will not be included in the grantor's estate for Federal estate tax purposes and will pass to the remainder beneficiaries. If the grantor dies before the end of the term, all of the trust property will likely be included in the grantor's gross estate for estate tax purposes and the annuity amount will continue to be paid to his estate. In this case, no transfer tax savings will result from the creation of the GRAT, but, ultimately, the grantor will be no worse off than if the grantor had not created the GRAT at all. For this reason, a GRAT may be a valuable estate planning technique that yields a high probability of success and little downside risk.

Published Articles (Cont.)

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