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Optimizing the use of GRATs

When you start has a lot to do with how much you leave your kids

By Robert N. Gordon

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The interest rates that are prevalent when financial advisers establish a GRAT for a client have a great effect on how much money can be transferred tax- free to the client's children.

The grantor retained annuity trust is a very popular vehicle used in estate planning/wealth transfer.

In a GRAT, the grantor (Dad) places assets into a trust. Dad receives an annuity from the trust that pays him back his principal plus interest through annuity payments.

If there is a remaining balance in the trust after paying Dad his annuity, it transfers free of gift and estate taxes to the kids. If there isn't enough in the trust at the end to fulfill the obligation to Dad, it is a “failed GRAT” and no wealth transfer takes place.

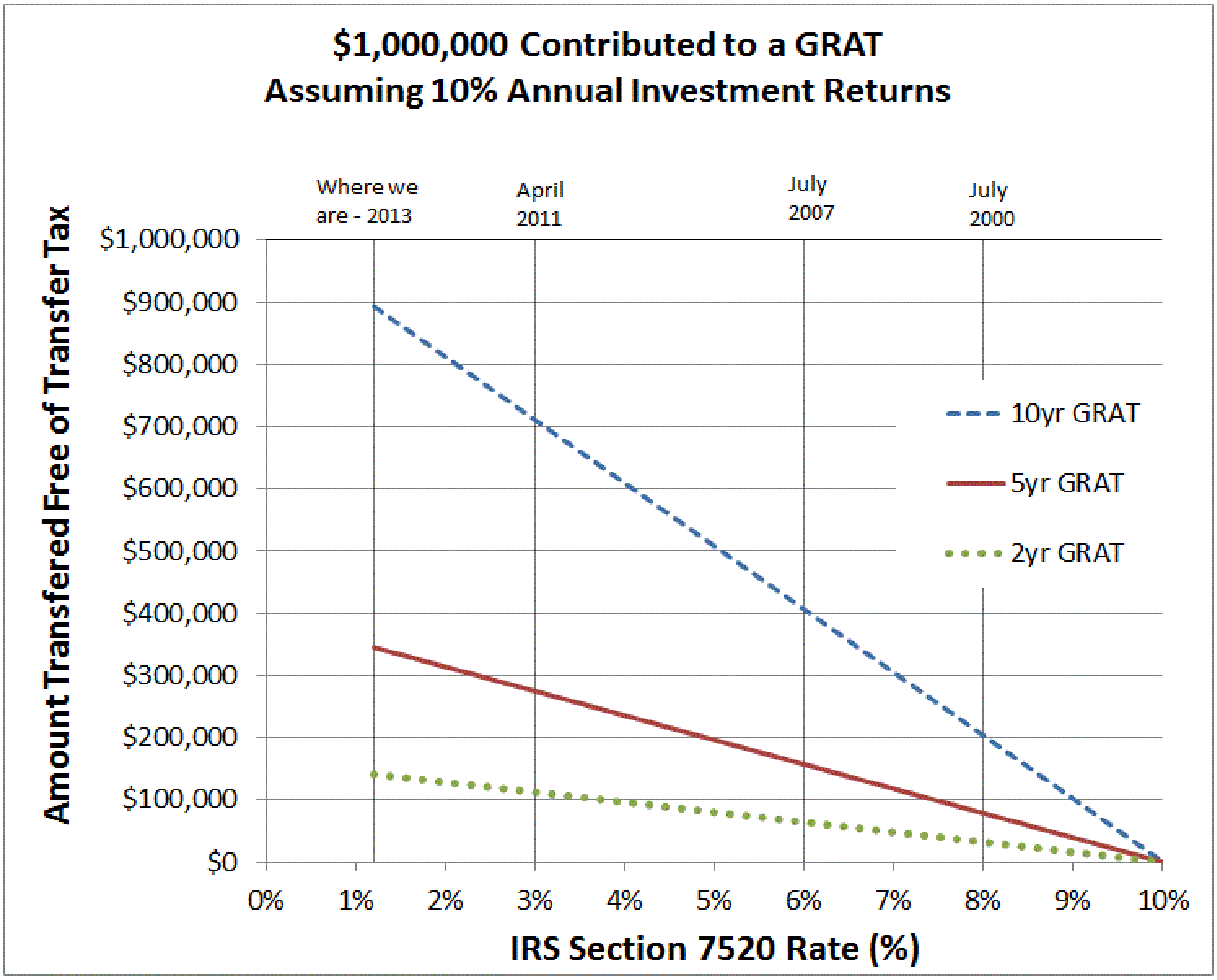
There are no penalties for having a “failed GRAT.” All that is lost is the initial set-up cost.

When a GRAT is established, the government looks to interest rates to determine the rate Dad should receive through his annuity payments. This rate is set at the inception and applies for the life of the GRAT.

This Section 7520 rate is announced monthly. It is at just 1.4%.

As you might imagine, giving Dad less return would leave the kids with more money in the GRAT at the end. The accompanying chart illustrates just how dramatic a difference there is in how much is left to the kids under different rate assumptions.

A GRAT funded with $1 million that produced a 10% annual return would leave the kids $900,000 tax free with today's 1.4% rate after 10 years. If the same GRAT was started in 2007 when rates were about 6%, the GRAT would move only $400,000 — less than half the amount.



Here are some tips for setting up a GRAT:

Use multiple GRATs. Don't put all the assets into one GRAT basket.

Put different asset classes into different GRATs. This way, there will probably be some failed GRATs and some successful ones. Assets that go in different directions might be best.

Don't procrastinate. President Barack Obama and Congress have proposals to limit GRATs' attractiveness. A GRAT created before legislative changes would be grandfathered.

Between the current low rates and tax reform fever in Washington, we think that anyone contemplating a GRAT should act now.

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It is a shame that we are surprised when the government addresses issues in a timely and expeditious manner. It is even more surprising when it takes more than one branch of government to get the job done.

As I wrote in my August 2012 column, floating net asset values for money market mutual funds would cause lots of tax headaches unless something was done. Well, the Securities and Exchange Commission met with the Internal Revenue Service, and lo and behold, we have Notice 2013-48, which fixes the thorniest issue: application of wash sale rules.

If the wash sale rules applied to money fund purchases and sales, there would be inconsistencies because losses would be deferred but gains would be taxable.

Notice 2013-48 proposes that the wash sale rules won't apply if a loss is 0.5% or less. The notice doesn't, however, address the nightmare of having to account for every purchase and sale at tax time.

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