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Q: What is a GRAT (Grantor retained annuity trusts)?

A: Grantor retained annuity trusts are a type of irrevocable trust. They potentially allow you to pay little to no estate or gift tax when passing large amounts of money from one generation to the next.

Q: How do GRAT's work?

A:

1. The grantor establishes the trust and funds it with cash, securities or any other assets they want to pass on to beneficiaries.

2. The grantor receives annuity payouts for a period they determine, usually two to five years. The total value of all annuity payments is more than or equal to the initial value, plus interest based on the 7520 rate. This an interest rate determined monthly by the Internal Revenue Service (IRS).

3. The annuity period ends. The remaining value of the trust gets passed on to a named beneficiary. This generally is a family member, such as a child or grandchild.

Q: Why should I create a GRAT?

A: GRAT creators are counting on the value of the assets they place in the trust appreciating more than predicted based on the 7520 rate the month they create the trust. That leftover money at the end of the annuity period — that is, any value above the total value of the initial assets plus interest at the defined 7520 rate — goes to the beneficiaries. That amount is not subject to the gift tax.

Q: Can you provide an example?

A. Let’s say you have an online business worth $10 million today and your business’s value grows by a rate of 20% above the 7520 rate. In 10 years, the business would be worth $83,211,799.

You would have to pay taxes on roughly $3,600,000 of annuity payments during this time period ($10,000,000 X 3.6% 7520 rate X 10 years), which would amount to $1,080,000 in taxes at a 30% effective tax rate.

However, you would also be able to transfer $73,211,799 million in wealth to your heir's estate tax free once the term of the GRAT expires. That would be an estate tax savings of about $29,300,000.

Q: Are there any risks?

A: Yes, one risk is that if you die, the annuity payments stop. Any money that’s left in the trust is subject to estate tax.

Another risk is that the assets in the trust won’t appreciate as much as anticipated. If the assets appreciate at a rate lower than the 7520 rate, all the money in the GRAT will end up going back to the grantor, without any excess to go to beneficiaries. The grantor will also have lost all the legal and administrative fees paid to set up the GRAT.