Of GRATs and GRUTs:
Shifting assets within the family

Let us imagine that among your assets you have $3 million in securities that you have planned to leave to your children. Now, however, you have come to believe that it may be better to give the assets to the kids now, because all further growth in value avoids potential estate and gift taxes. But two problems present themselves. First, there's a very real gift tax cost for a $3 million gift—at least several hundred thousand dollars, and more if you've already used up a portion of your estate and gift tax credit. Second, you may not really be ready to part with the assets; you may want the income, or at least some of it.

The solution: Consider a Grantor Retained Annuity Trust (GRAT) or Grantor Retained Unitrust (GRUT).

How the trusts work

In a nutshell, you transfer the $3 million to an irrevocable trust to last for a specific time period, say ten years. You receive an annual income from the trust, and after ten years the assets pass to your beneficiaries.

There are two ways to define your retained income interest. In most cases the income is set at a fixed dollar amount, or a fixed percentage of the initial value of the trust. This is an annuity, putting the "A" in GRAT. Alternatively, the income interest may be a fixed percentage of the value of the trust, recomputed each year. This is called a "unitrust" income interest, and it puts the "U" in GRUT.

A unitrust income interest can grow over time as the value of the trust grows. However, this fights against the primary objective of the trust: transferring the largest amount to beneficiaries at the lowest possible tax cost. That is why GRATs usually are preferred to GRUTs.

Because the trust is irrevocable, at the moment that it is created, a taxable gift has been made to the beneficiaries. However, the taxable value of the gift is reduced to reflect the value of the income interest retained by the grantor. The longer the trust lasts, and the higher the retained income interest, the lower will be the taxable value of the gift.

Downsides

GRATs and GRUTs are not for everybody, nor are they suitable for every type of asset. A few of the negatives to keep in mind:

- The grantor loses control over trust assets, including control over buy and sell decisions.
- Because these trusts are grantor trusts for income tax purposes, all the trust income will be taxable to the grantor, whether or not it is distributed. For this reason such trusts are normally invested for capital appreciation rather than income, to reduce current taxation.
- Should the donor die before the expiration of the term of the trust, the full value of the assets will be included in his or her taxable estate. Therefore, this type of plan is more likely to succeed for younger donors with a longer life expectancy.
- GRATs and GRUTs are not good tools for dealing with the generation-skipping transfer tax. Gifts to grandchildren probably should be taken care of separately.

Looking longer term

When the grantor's income interest ends, the trust assets may be distributed to the designated family members. Alternatively, the assets may be held in further trust for their benefit. Careful trust drafting is needed to ensure that the successor trust will not be included in the grantor's estate.

The GRAT and the GRUT are good tax-saving tools. They can be used to help shape an overall estate plan, putting part of the plan into effect during life and keeping down the total transfer taxes imposed on the family.

Any developments occurring after January 1, 2009, are not reflected in this article.